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S. Hrg. 103–293

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1993

Y 4. B 22/3: S. HRG. 103-293

Federal Reserve's Second Monetary P...

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BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

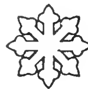
FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 22, 1993

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE

74–457 CC WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-043241-3

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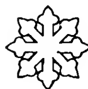

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1993

THURSDAY, JULY 22, 1993

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.

Before we start our hearing this morning with Fed Chairman Greenspan, I want to announce for the record that the committee will be voting to favorably report the following nominations: Arthur Levitt, to be Chairman of the Securities and Exchange Commission; Alan Blinder and Joseph Stiglitz, to be members of the President's Council of Economic Advisers; Richard Carnell, to be the Assistant Secretary of the Treasury for Financial Institutions; Susan Gaffney, to be Inspector General of the Department of Housing and Urban Development; and G. Edward DeSeve, to be the Chief Financial Officer of the Department of Housing and Urban Development.

So if there is no objection, the period of voting will begin now and it will extend until this hearing concludes. If a quorum of Members arrives to cast their votes in that time, the nominations will be reported to the full Senate today. Without objection, then, we will proceed in that fashion.

Let me now welcome our Fed Chairman, Alan Greenspan, back to the committee today. We appreciate his appearance.

There is no issue that's probably more important that comes before this committee in terms of dealing with the economy than the oversight of the Federal Reserve Board and monetary policy.

The President has properly and necessarily made economic policy and economic growth his top priority. All of the public opinion polls that one can see show that that is how the American people view it as well.

At the present time, we are working to get the deficit reduction package in place. I am serving as one of the conferees from the Finance Committee in that effort. In fact, we'll be working on it just a little bit later this morning and I may ask Chairman Sarbanes to sit in for me when I'm called in to that Senate-House Conference Committee.

I think it's fair to say that it's not possible to accomplish the minimum level of job growth of 8 million new private-sector jobs over the next 4 years if we don't have both our fiscal and monetary policy well synchronized.

In fact, if we have a fiscal policy that is contractionary then we must have a compensating adjustment in monetary policy or we will not see the economic growth and job creation that the country needs.

I just want to say at this point, Mr. Chairman, we've got a very serious job problem in the country. You've been reading and follow the news carefully. Just this week, major companies announced that they are shearing off many employees. Procter & Gamble is a recent example, but there are many more.

I'm running into a situation in my home State of Michigan. The University of Michigan is certainly one of America's, and probably the world's, flagship universities. We've got students coming out with straight 4.0 averages, a lot of extracurricular activities, very fine records, worked their way through school in many cases with the help and sacrifice of their families, circulating their resumes and not findings any jobs and, in many cases, going back to move in with their parents after working their way to a very fine record in college. That's one manifestation of the problem.

Another manifestation of the problem is that there are a lot of people that are either losing ground or losing jobs—people that earn anywhere from, say, $40,000 to $150,000 a year.

Fortune magazine, Business Week, a lot of the major business periodicals have been running cover stories on this situation as people are being washed out of the job market—a lot of it in California due to defense cutbacks and bank consolidations and so forth. But the pattern, while it differs a bit from one area of the country, to the next is a very large pool of unemployed people, including the new people coming into the work force and finding it very difficult to find work.

This is unusual at this stage of a presumed recovery. We've talked before—I won't get the charts out here now—but we've had a situation where in past recoveries, we've had job growth that has not only regained jobs lost during the recession, but would have us way up in positive ground in terms of net job additions to the economy. We have not seen that this time.

You have commented on that before. You've said, in effect, and I'm just sort of paraphrasing what I've heard you say to us and others, that we have new economic conditions on our hands. They're global in scope. It's hard to understand exactly what's going on in terms of why we're not getting the kind of robust job recovery at least this late after the onset of a recession, such as we have seen in other business cycles.

In any event, there is great anxiety about it out in the country. The polls that I've seen indicate that fully 80 percent-plus of the American people think we're on the wrong economic track going into the future, and they're very uncertain about it and they're holding back in certain ways just in terms of their decisions—both their buying and investment decisions.

As you well know, even though interest rates right now are quite low, we're not seeing the kind of normal spurt in new home buying

and new home construction that one might expect from such a significant reduction in long-term interest rates.

I deduce from that that people are feeling very uncertain about their circumstances. Most families have two wage-earners now and if one or both are in jeopardy of losing their jobs or experiencing cutbacks in hours, it makes them, I think, very unlikely to feel that they can tackle a new home purchase.

So we've not seen that element of recovery coming along as one might have expected that it would with mortgage interest rates down where they are at the present time.

In this picture, I keep hearing comments coming from the Fed, some from individual members of the Fed, some from the Fed overall policy directives, that there appears to be a very keen concern or a worry about inflation.

I look around the landscape and I don't see much inflation. In fact, I see a lot of deflation. I see deflation in commercial real estate properties. I see deflation in gasoline prices. I see it in building rents for commercial space. I see it in housing prices. It's not just in one or two States. I see a lot of deflation in wages. There are a lot of people that are sliding backward just in terms of their real incomes.

So, when I look out on the landscape and I see all these deflationary pressure—that's not the whole story, but there's a lot of it—it's awfully hard to net out from that, come back and say, there is some looming inflationary threat. And yet, that seems to be the signal that is coming out. I don't know whether that's a conscious desire or whether it's accidental, but I think that the Fed is clearly giving the signal that it has a heightened anxiety about inflation really causing a problem for us here in the foreseeable future.

Frankly, I don't see it. I know we had a couple of months of data early in the year that appear to be anomalies, but I think we need more job lift and I think we need more economic lift. I would hope that the Fed would not get into a monetary tightening situation that would choke off this struggling recovery, such as it is.

We're just not getting the kind of job growth that I think we should be seeing. I would hope that monetary policy, especially as we're trying to reduce this deficit by about $500 billion over what it otherwise would be over the next 5 years, will work in a way to provide some lift to the economy and not work in a way that would counteract that and put more drag on it.

I might just say to you that we had before us just a matter of a few days ago two colleagues of yours from the economics profession—in fact, we had actually four. But Henry Kaufman was here, who I know you know and respect, as he does you, and Paul Samuelson. We had the two nominees for the Council of Economic Advisers—Alan Blinder and Joseph Stiglitz, both, I think it's fair to say, esteemed economists.

They don't detect any inflationary pressure out there and are very much concerned that we are not doing enough to get some lift into the economy—not that we overheat it, or if there is anything overheated at this time, I'd like you to tell me where it is today because I'm certainly not seeing that.

So I would hope that you could tell us today what the Fed can do to perhaps get a little more muscle into the economic recovery

and if you see some serious inflationary concern out there that is escaping me and I think many others here, I'd like to hear what that is.

I'll put the rest of my statement in the record.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

First of all, Mr. Chairman, I join you in welcoming our Federal Reserve Board Chairman, Alan Greenspan, to the committee to discuss the issues vital to this Nation and our economic well-being.

Mr. Chairman, as you know, we have discussed and worked together to deal with this problem. There is still a credit crunch for small businesses. The choke-hold on small business credit is strangling our economy. And when we talk about the creation of jobs, that's where it's going to come from, from the small businesses of America.

So notwithstanding lower interest rates, they will not help the small business community nearly as much as they could without there being credit.

I strongly believe that the best long-term solution to the credit crunch is to open up the capital markets to small businesses by facilitating securitization and the development of a secondary trading market in securities backed by small business loans.

Securitization of residential mortgages has eliminated the credit crunch for our Nation's home buyers. And at one point in time, there was a credit crunch. It wasn't easy to get mortgages. But using that technology has opened up tens of billions of dollars.

That's why I introduced, and a majority of this committee has introduced legislation that would remove unnecessary regulatory impediments to the securitization of small businesses.

For the past few months, I've worked very closely with you, Mr. Chairman. I want to thank you and the staff, and our staffs have made some great progress, and with Chairman Greenspan and other bank regulators, to develop a way to change the current capital rules in order to increase the availability of credit by the method which I just indicated, and doing it in a way which will not impact on the soundness and safety of our Nation's institutions.

I'm pleased——

The CHAIRMAN. Would you just yield at that point to let me say that I agree with you on that point and we're working together on that. We'd like the help of the Fed in refining that proposal to make sure that we've got something we can enact and that will work.

Senator D'AMATO. Well, thank you, Mr. Chairman. To that extent, I'm very pleased with the progress that we've made with the regulators. Chairman Greenspan's cooperation has been outstanding and he's continued to support this effort.

We really are down to the minor points, some very technical points that I think we can come to an agreement with because we don't want to move forward without the support of the Federal Reserve. The Federal Reserve's blessing is important. And the administration has been cooperative in this area.

I believe with all of the business of job creation that we talk about, and programs to put people to work, if we're going to do that with Federal dollars, that's not the way to get this economy going.

The way to do it is to clear out the blockage of the arteries, so to speak. Make it possible for that capital to flow so that small businesses can get credit where they are creditworthy, so that we can encourage banks to become involved in this activity where now they are discouraged unnecessarily.

I hope that we can move toward this. I want to thank the Chairman for his cooperation. We've called and he has responded, and we've made some great progress. It's not always easy. There's pride of authorship. There's fear. There's protection of the system that exists. Institutional mentalities are generally, whether it's in the Senate of the United States or in the private sector, are skeptical of change. We've done it this way. It's been sound. It's been efficient. We know there are problems and we change it. And so, it has been that give and take. But we've made, I want to report to the committee that we've made some very real progress, and I want to thank the Chairman for it.

I might take just another minute in saying, I've reviewed the Chairman's extensive testimony that he has submitted and I agree completely with the Chairman's observations that a credible and effective fiscal package would promise an improved outlook for sustained, long-term interest rates and a better environment for the private sector and investment.

However, we will never achieve either objective for full employment or balanced growth without a credible and effective fiscal package. And we certainly don't have them under the administration's budget.

The administration's budget has not proposed a sound fiscal place for us to start. It has not corrected the material deficiencies. And as to the shaping up, it's a combination of tax increases and spending increases.

That's not going to promote either a balanced economic growth or generate jobs. No nation has ever taxed itself into prosperity. The answer is we've got to cut spending. And we're not cutting spending nearly enough. Aside from the military cuts in spending, there's almost no cuts. We haven't frozen spending. We haven't really gone after programs that are marginal in light of our economic interest. If we really want to get this economy going and send a real message to the economic community, let's cut spending. And we don't have the necessity of increasing taxes. That's the answer. That's where we have to go.

And so, while we can claim that we've reduced what the deficiency or the deficit would have been by $500 billion, the fact of the matter is that at the end of that 5-year period of time, the curve just begins to go right back up in terms of those deficits and we haven't really addressed the major problem. And that is cutting spending.

The other day, I had a Taxasaurus on the floor of the Senate. That was a big carnivorous animal that wants more and more taxes. Well, let me tell you—his big brother is coming out. I just haven't decided when to show him. But he's growing. He is Spendasaurus Rex, the king of spending. And let me tell you, he

has a voracious appetite for your money. And he doesn't stop. I'm telling you, Spendasaurus is coming out. I'm just not sure whether I'll bring him out today or next week, but he's coming out, and he's there. He's growing in my office, literally. He's just thirsting over the money. He hears the new programs—national service program.

Talking about national service—you come, you work, you help, you get a little stipend. I didn't know you got $22,000 for national service.

I have to tell you something. As my friend, Mayor Koch would say, the poverty pimps in New York, they're going to be happy with this national service. They're lining up. They're licking their chops.

So Spendasaurus Rex is coming out. And we ought to kill him. Slay him. Kill him. If you kill him, then you're going to get this economy to grow.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I'm pleased to join with you in welcoming Chairman Greenspan to the committee for what I hope will be a very serious discussion of what the Nation's economic outlook is and what the Nation's economic policies ought to be.

Chairman Greenspan's testimony this week comes at a significant time. The House-Senate Conference Committee on the budget reconciliation bill is meeting right now, so to speak, and there is a reasonable prospect that Congress will complete action on a very substantial deficit reduction package within the next 2 weeks. If that occurs, then a critical step would have been taken toward putting our country's fiscal policy on a sounder footing.

Now I've not seen the movie, "Jurassic Park," so I'm not going to get into a dissertation on dinosaurs, as my colleague has done a little bit here this morning.

Let me say that the deficit reduction package represents both very substantial cuts in spending and also increases in revenue. The increases in revenue, 80 percent of them will come from people with incomes over $100,000 a year. In other words, it will come from the very top end of the income scale. That's 80 percent of those revenues. Most of the balance will come from whatever energy tax there is, which now looks increasingly like a fairly modest increase in the gasoline tax.

Now, assuming this very important step in fiscal policy, it's actually one that's been urged on us repeatedly by the Chairman and by others in its broad outlines. We've consistently been told the Congress has to have a fiscal policy that is addressed toward deficit reduction. Of course, that's contractionary in its impact on the economy and therefore, it carries with it the risk of pulling spending out of the income stream, public spending through the cuts and private spending through the revenue increases. Although the fact that most of it is at the top significantly ameliorates that since most of those people are in a position to adjust their spending habits on the basis of accumulated wealth in order to sustain their consumption, an option not available to low- and middle-income people.

The question will then arise as to what is the appropriate monetary policy to complement the fiscal policy adopted by the Congress and the President. And of course, that is the issue which we will be addressing here today and it's a very important issue, indeed.

The Chairman appeared on Tuesday before the House and we had the next day a story headlined, "Long Rates Soar as Aftershock of Greenspan's Speech Takes Toll on Bonds."

So the real-life impacts in terms of the effort to read the tea leaves and divine what the Federal Reserve and the Open Market Committee may do with respect to monetary policy, as we get a contracting fiscal policy.

This committee held a hearing on July 1, 1993, in which we had Paul Samuelson, the very distinguished professor of economics at MIT, and the first recipient of the Nobel Prize for economics, and Henry Kaufman, one of Wall Street's most respected financial analysts, before us to testify. I want to take just a moment, Mr. Chairman, to help set the stage for this hearing to quote just briefly from their testimony. Paul Samuelson said and I quote:

> Coordinating Federal Reserve monetary policy with austere fiscal deficit reduction can be the single most important path for the 1990's. Leaning against the wind of inflationary overheating is a vital duty of the Federal Reserve as the central bank. It goes along with the Fed's vital duty to lean against the winds of self-aggravating recession.
>
> The hardest task for an intelligent and responsible Federal Reserve will be to distinguish between micro-caused inflation due to one-time supply shocks and tax changes, and macro-caused inflation brought on by diminished slack in personal power and productive capacity.
>
> On July 1, 1993, the weight of the evidence is against our economy as being one constrained by resource scarcity and on the verge of macro-overheating. Later, when and if the weight of the evidence shifts, that will be the good time to pump gently on the brakes. That time is not now.

Now, similarly, Henry Kaufman stated, and I quote him:

> A more systematic analysis of the present inflationary potential within the U.S. economy does not justify either exaggerated inflationary expectations or a preemptive tightening by the Federal Reserve. Inflation, as depicted in the most commonly watched measure, the Consumer Price Index, is exaggerating actual price pressures. Inflation is not found in the business community and it is not revealed in speculative activity in the great majority of product markets.
>
> There is no evidence whatsoever of a surge in credit demand on the part of those wishing to finance speculative holdings of inventories, commodities, or real estate, in contrast to the conditions that prevailed during the previous run-up in the rate of inflation in the late 1970's.
>
> There is no evidence of tightening in labor markets that would presage an escalation of wage settlements. To the contrary, as I have detailed, labor markets are soft.

And Henry Kaufman went on to say, and I continue to quote him:

> The time will come, no one knows precisely when, perhaps in 1994, perhaps not until 1995 or 1996, when the business recovery will have matured. Excess capacity will have been worked off. Labor markets will become tauter. The economic recovery abroad will have begun. Commodity prices will have turned higher across the board. Real estate prices will have firmed. And credit demands will have become conspicuously stronger.
>
> Then we will want the Federal Reserve to act with dispatch and determination to resist forcibly any build-up of inflationary pressures.
>
> But none of those circumstances prevail today.

Now, Mr. Chairman, from mid-1991 until December 22, 1992, the Federal Open Market Committee generally voted to tilt toward easing in the conduct of monetary policy. This meant that the FOMC

authorized the Chairman of the Federal Reserve, at his discretion, to lower the Federal funds rate by as much as ½ percent.

At its meeting on December 22, the FOMC voted to shift toward a so-called symmetric policy, which indicates no tilt toward either lower or higher interest rates. This symmetric policy was reaffirmed in meetings of the Open Market Committee on February 2 and March 23, 1993.

However, at its meeting on May 18, the Open Market Committee voted to tilt toward higher short-term interest rates, presumably—I don't know—out of concern for inflation figures that came out for the first 4 months of this year.

In the 2 months since the May meeting, we have had reports of virtually no inflation for May and June, but discouraging reports on industrial production, consumer confidence, purchasing managers' forecasts, foreign growth, and other measures.

Although the FOMC met again on July 6 and 7, we will not learn for sometime whether they have maintained a tilt toward higher interest rates or return to a symmetric position.

Now I want to address just very briefly because it's come up, this notion that interest rates are very low. And I know an assertion is made with respect to the Federal funds rate as being perhaps even negative, somewhat positive. But the fact of the matter is, and I want to quote now from the daily economic comment from Goldman, Sachs following the Chairman's testimony on Tuesday before the House.

The fact that the Federal funds rate—because this is often cited to show that there's been a very accommodative monetary policy. And people keep saying, well, that shows that interest rates are very low and so forth.

The fact that the Federal funds rate is at or below the rate of inflation does not imply that monetary policy is too accommodative. What matters is the cost of credit faced by households and business, which is much higher.

Now, the fact is if you look at the real prime rate, which is the nominal rate less the 12 month CPI change, what we find is that the real prime rate, which has come down through the 1980's, thank heavens, but is still high in an historical comparison. This begins in 1956 and comes forward. And in fact, part of that is because the banks are maintaining for this point in a recession a larger spread between the Federal funds rate and the rate that they're charging to their customers, the real prime rate.

That spread has been larger at this point in a recovery than has historically been the case. And as a consequence, in part because of that, the real prime rate, which is actually the relevant rate for economic activity. The Federal funds rate is the rate at which the banks can get their money. This is the rate in real terms that people are paying out on the street in order to get credit, in order to engage in economic activity. And as I say, this rate historically is not low.

Now, finally, let me simply say to the Chairman that in light of the economic conditions which I quoted before described by Paul Samuelson and Henry Kaufman in their very compelling testimony before this Committee, and indeed, in light of the very headwinds that Chairman Greenspan has talked about before in his testimony, coming from fiscal retrenchment and balance sheet restruc-

turing in the economy, it seems to me incumbent on the Federal Reserve to do its part to maintain strong growth and job creation.

I look forward to exploring this and other issues with the Chairman this morning.

Thank you very much.

The CHAIRMAN. Thank you.

Senator Roth.

OPENING STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Senator ROTH. Well, thank you, Mr. Chairman. It's always a pleasure to welcome Mr. Greenspan.

During the last couple of months, I, like everybody else, have been listening carefully to the President as he attempted to explain how precisely the largest tax increase in history, coupled with the largest 4-year increase in the national debt, are going to stimulate economic growth and spur job creation. What I hear disturbs me greatly.

As you listen this morning, I think it's a fair statement that everyone seems to agree that, taken alone, the tax increase we are preparing to enact will substantially slow economic growth for sometime to come.

It's been already brought out, independent economic analysis of the Clinton proposal show, for example, that it would reduce the rate of economic growth by about one-fourth, destroy hundreds of thousands of jobs. Indeed, some of the most articulate defenders of the President's plan are on this committee and they acknowledge, as we just heard, their concern that the reconciliation bill will dramatically slow economic activity. In fact, right here in this committee room, my colleagues on several occasions have expressed their fear that we face a real danger of recession as a direct consequence of the Clinton economic package.

Now, as I listen to my colleagues and to spokespeople for the administration, it comes down to this—the President's economic program will slow economic activity, even perhaps to the point of bringing on a recession. Therefore, it's up to the Fed to offset and counteract this highly contractionary fiscal policy with loose monetary policy.

Mr. Chairman, we're going to all be very interested in what you have to say on this matter. Is it your view that, as Mr. Samuelson says, monetary policy rather than fiscal policy should be the major macro-economic weapons for assuring a healthy recovery?

Or is it your view that, everything else constant, economic growth will be maximized over the long run if the central bank focuses on producing and maintaining price-level stability?

Mr. Chairman, this economic strategy is not a riverboat gamble. It's a guaranteed snake eyes for the economy. It won't work. Markets are too sensitive and too sophisticated to be fooled by some of the ploys being suggested and if we attempt to put this economic strategy into play of loose monetary policy, we could very well, it seems to me, end up with the worst of both worlds—reduced economic growth, even to the point of recession, and higher inflation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. And thank you, Mr. Greenspan, for being with us.

I want to thank you for giving your service to the country in serving in the capacity you do because it certainly is not an easy job and it's not one free of anxiety.

You have been a dedicated fighter of inflation since you've been with the Federal Reserve and I want to thank you for it and I hope you will maintain that policy. It would be so easy to be mesmerized into believing that loose money would bail us out of an economic downturn.

I think the exact opposite is true, and that's the reason I'm so concerned, as so many of us are, that the budget package that's coming through involves enormous tax increases. And they're real tax increases. They're real money. They're going to take money out of the economy. The so-called cuts are absolutely a facade. They simply do not exist. And until we face reality and really cut spending, with the exception of the defense budget, everything else is a facade. There's no cut. They talk about it as if they were going to cut the budget, but, in its simplest terms, if they got $1,000 last year, they ask for $1,500 this year, they get $1,400, and they wail, they had a budget cut.

We're going to have to really cut it.

I hope you will maintain the strict and very close surveillance of the economy and guard against inflation because inflation is somewhat akin to a snake. You don't really see him until he bites you. It's there before you find it. And I hope you'll maintain that position and I thank you for your service.

The CHAIRMAN. Senator Sasser, chairman of the Budget Committee.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Thank you, Mr. Chairman.

I want to welcome our good friend, the Chairman, Dr. Greenspan, here this morning. I always look forward to his presentation of the semiannual monetary policy report.

I am particularly eager to hear your thoughts today, Dr. Greenspan, on the coordination of monetary policy and fiscal policy. In my judgment, this coordination has probably never been more critical than it is right now.

Now, following the bold leadership of the administration, the Congress is on the cusp of enacting a record $500 million deficit reduction package. We've learned that we can't balance the budget by depriving the Federal Treasury of revenues. We've learned that with the tax cut of 1981, which benefited primarily the wealthy in this country, and we're still reeling from that today. We won't dwell on past history. We simply have to play the hand that's been dealt us.

Now this deficit reduction package that this administration has presented has been applauded by our allies around the world. When this President went to the G–7 meeting, he could speak with boldness and with confidence for the first time in well over a decade that the U.S. Government was moving to get its fiscal house

in order as our allies had been urging us to do for many, many years.

Wall Street applauds this deficit reduction package that this administration has proposed. They think that it is a necessary step, as I read Wall Street and the financial circles, in getting our fiscal house in order.

So we're heading down the road of necessary fiscal contraction. We're doing it to put this Government on a sound financial footing once again. The stakes are very high. Millions of jobs and the future living standards of tens of millions of Americans are on the line. We can't afford failure.

In 1990, we entered into a bipartisan deficit reduction agreement. But that agreement was overwhelmed by a recession and subsequent stagnation. Our timing today seems to be a little better. The economy is slowly but surely coming out of recession; whereas, as we learned in 1990, just as we entered into the budget agreement, the economy was falling into recession or, as a matter of fact, was already in one, but we weren't aware of it.

Then in 1990, there was concern about rising oil prices because Iraq had overwhelmed Kuwait and we were worried about them overwhelming Saudi Arabia.

Well, today, oil prices are down. And more generally, as a recent Merrill-Lynch analysis concluded, and I quote from that analysis:

> The latest price reports were downright deflationary.

Now, the timing is better but it's certainly not perfect as far as the recovery is concerned because it's a very slow one. In fact, the first quarter real GDP grew at just seven-tenths of 1 percent, disappointing. And last week, Dr. Greenspan, as you know, the Fed reported that industrial production fell in June for the first time since last September.

So, clearly, as Senator Sarbanes and I have worried out loud in times past, fiscal contraction entails down-side risk. And this is where, Dr. Greenspan, I must urge once again that the Fed must pick up the slack.

In my judgment, if we're going to get this deficit down, if we're going to keep the economy moving, then the Federal Reserve has got to be a full partner in this endeavor. And monetary coordination with the fiscal contractionary movements of the Federal Government I think are essential.

This does not mean that we expect the Fed to act tomorrow, although I, for one, would frankly welcome it. But I think the Fed must stand ready to act decisively if the down-side risk that we're talking about actually becomes a down-side reality.

Coordination of fiscal policy and monetary policy is essential. In fact, it is critical and crucial to the success of this deficit reduction plan, in my judgment, and for the health of our economy.

So, Mr. Chairman, as always, I look forward to hearing from Dr. Greenspan. He's always informative. He's always very perceptive in his comments. I always learn a lot from what he has to say.

Thank you.

The CHAIRMAN. Thank you very much.

Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

I too welcome Dr. Greenspan.

As a newcomer to the Senate, I'm primarily attending these things in order to learn. I have discovered from the debate today and others that I'm going to have to learn a new vocabulary. Where I come from, some of the comments that are made in the name of economics strike a somewhat difficult tone.

We've heard, for example, that the 1981 Tax Act deprived the Treasury of revenues. Where I come from, if you look at the fact that the revenues have been going up every year since 1981, you have a hard time understanding that. But I will learn. I'm trying hard to pick up the new jargon.

There is one thing I do know and the one comment I will make, and then go on to hear Dr. Greenspan. Small business grows a whole lot better on internally generated funds than it does on borrowed funds. We do a whole lot better if the small businessman is able to keep the funds he earns than if he has to pay those funds to the Government and then go out and borrow the difference.

I would hope that we would keep that in mind as we face this whole question of how jobs are created.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Mack.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman. Welcome, Mr. Greenspan.

I'd like to set the record straight on Chairman Greenspan and the Clinton tax package. The news media continues to report Mr. Greenspan's ringing endorsement of that plan. They're wrong. Wednesday's New York Times was but another example of the incorrect reporting on what Mr. Greenspan has said about the President's tax plan.

The Times reported that Mr. Greenspan used his testimony on Tuesday, "to badger Congress to approve the Clinton administration's plan to cut the deficit by $500 billion over 5 years."

I've listened to Mr. Greenspan's comments and past testimony before this committee. I have read his testimony that he presented to the House Banking Committee 2 days ago. Nowhere has he said that he endorses, supports, or otherwise approves of the Clinton plan. And I might just stop and put this in political terms that maybe all of us would understand.

If Ronald Reagan had come to Florida to speak on my behalf and failed to use the terms either support or endorse, the headlines the next day would have reported that President Reagan failed to endorse or support Candidate Mack in his quest.

Nowhere has he advocated that the Clinton plan will actually result in $500 billion in real deficit reduction. Nowhere has he claimed that the make-up of the Clinton plan, which doesn't cut spending and is overwhelming tax increases, is the right one. In fact, although Mr. Greenspan has been characteristically careful in describing his position on the Clinton plan, he has been clear to warn of the negative effects of higher taxes.

Let me read some of the recent quotes from Mr. Greenspan. In March of this year, before the Senate Finance Committee, he said, and I quote:

Stabilizing the deficit-to-GDP ratio solely from the receipt side, not to mention reducing it, will necessarily require ever increasing tax rates.

Let me underscore tax rates.

This would surely undercut incentives for risk-taking and inevitably, dampen the long-term growth and tax revenue potential of our economy. The gap between spending and revenues will not close under such conditions.

Thus, there is no alternative to achieving much slower growth of outlays if deficit control is our objective.

On Tuesday, before the House Banking Committee, Mr. Greenspan said, and again I quote:

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partially offset by some business spending reductions as a consequence of concern about the effects of pending tax increases.

And further quote:

It seems that the prospective cuts in the deficit are having a variety of substantial economic effects well in advance of any actual change in taxes or in projected outlay.

Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans.

Contrary to what has been reported, these statements do not convey endorsement of the Clinton package. They tell us that we need to cut spending first because the threat of higher taxes will punish the economy and not lower the deficit.

I'm convinced that the lower interest rates that we have seen in recent months are not because the economy is enthusiastically welcoming the prospect of deficit reduction. Instead, I believe that the tax threat from the Clinton plan has so staggered the economy, that interest rates have fallen in the prospect of a no-growth future.

If Congress is serious about reducing the deficit—and let me clarify. If the conferees are serious about reducing the deficit, they will throw out the Clinton tax plan and cut spending first. That's the only path to serious deficit reduction.

And just one further comment with respect to my colleagues' continual effort to pursue the Fed with respect to an accommodating monetary policy.

It seems to me that, based on your own words, that a contraction will take place as a result of the deficit plan that has been put forward. To me, that translates into fewer goods. If you're going to have a policy that is going to create fewer goods, it seems to me that it's insane to suggest that you should at the same time increase money supply, which is the clearest definition for inflation—more dollars chasing fewer goods.

And so I state to the Chairman, I think it is important that you continue to express the independence of the Fed and follow the course that you believe is in the best long-term interest of this country.

The CHAIRMAN. Thank you.

Senator Kerry.

Senator SARBANES. Will the Senator yield to me for a second?

Senator KERRY. I'd be delighted to.

Senator SARBANES. Since the last comment apparently referred to some comments on this side.

Obviously, the overall impact on the workings of the economy is going to be affected both by fiscal and monetary policy.

Now if you're trying to bring the deficit down, which is now recognized as a major objective, you have to have a fiscal policy that seeks to do that. And that's what the President is trying to accomplish with a balanced program of spending cuts and revenue increases.

I know my colleagues constantly assert that's not the case, but that's just not true. This is a package that has significant spending cuts in it and it has significant revenue increases.

Now any projection solely on the basis of fiscal policy as to what will happen to the economy leaves out an important dimension to our economic growth because if you have a monetary policy that provides an expansionary opportunity, it can offset and, indeed, prevail over a fiscal policy which is trying to get at the deficit problem, which people have argued for years needs to be addressed.

So you have to take the combination of your fiscal and monetary policy in order to make a calculation as to the direction in which the economy is likely to go.

Now the good news on the interest rates on the bonds is very helpful to the economy. Now, you've got plenty of capacity. So the extra boost you get from the monetary policy can easily be translated into additional production. That's the fact of the matter.

If people use this monetary policy and lower interest rates to engage in economic activity, which is one of the premises of this approach, there's plenty of slack in the economy in terms of industrial capacity and workers to respond to that demand. So that's not inflationary. You're not, as Kaufman said in his quote, you're not anywhere close to pressing up against either the labor supply or industrial capacity.

I thank the Senator.

OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. I'm delighted. Mr. Chairman, thank you very much.

I listened to part of the dialog on television before coming over here and I picked some of the last parts of it which I guess this discussion inevitably winds up becoming somewhat partisan, which none of us I suppose should be too surprised about around here.

At least it ought to be based somewhat on the truth. And the truth is that over the last years, when we had a Republican President who made a hell of a lot of noise about the deficit, I don't remember those appropriation bills coming back here with vetoes on them. They could have. Time and again, they could have. But they didn't.

Every bit of that spending has the signature of the President of the United States on it, who was a Republican for those 12 years. It didn't have to. Could have sent it back in a veto time and again. Never happened. Rarely happened, I should say.

The fact is that we're spending what we're spending because a Republican President put his signature and signed it into law, time and again.

So here we have the largest deficit reduction package in history. Not one spending cut offered by the Republicans when it was in the committee. Not one at the Finance Committee. Basically, the Republican Party has walked away from this effort, said, we're not going to vote for anything. It's tax and spend, tax and spend.

There isn't one person of intelligence in America that I know of who looks at this economy who says that you can do this without finding some revenue, that you have to find some revenue.

Now I'd love to make an arrangement here where we have an agreement that we will go to the floor of the Senate and the House and let 51 votes carry the day and put it all up for a vote. Let's vote. Vote on the Ag Department stuff.

We tried to have a vote the other day on the wood and mohair subsidy. The Senator from Texas was one of those down there defending it, saying, by God, the money comes from tariffs. Therefore, taxpayers aren't really paying for it.

But the fact is $675 million is scored and because it's scored, we have to find that $675 million somewhere else. It's not money that goes to education. It's not money that goes for the capital gains reduction. It's not money that goes into something else because the $675 million is scored elsewhere, so we have to find it elsewhere. It does cost the taxpayer some money.

The Senator from Texas didn't vote for that because he's got people down in Texas. He's got one farmer down there who got $661,000 worth of that subsidy by dividing it up into four partnerships in his own family.

So Americans are paying for a 1954-passed national strategy to have mohair in our uniforms when we don't have any mohair in our uniforms in America any more.

Does the average American wonder why we look like fools up here? This is ridiculous.

And where is the Republican Party? We're not going to vote on it. We're just going to call the Democrats tax and spenders. Now that's terrific. No wonder we have a predicament here.

I'll tell you, I think everybody in this country understands what's happening. 25,000 more jobs were lost today. We just read it in the papers today. We've got a slow recovery in America and we are contracting spending. We're doing exactly what Mr. Greenspan said to do—reduce spending. We're doing it. The largest spending reductions, $250, $260 billion worth, more in spending cuts than we have in taxes.

Now I don't like the number of taxes. I also am convinced we can get more spending cuts. No question about it. But you could eliminate 100 percent of the domestic discretionary budget of the entire Federal Government and you'd still have $150 billion of deficit, folks.

Now I am concerned with respect to this hearing, which was not meant to be about that, per se. The Chairman was before the House the other day. The Fed has released its minutes from the Open Market Committee meeting of 6 weeks ago, indicating that the concern at the Fed now appears to be the potential of inflation again.

And I'm reminded of the consistency of our fighting past wars, fighting the current war by using the strategy of the past war.

The problem is that at this moment we're contracting spending, we're really not doing what we ought to do in terms of investment in this country, and we have a gap in investment relative to where we were in the great years of growth and expansion after World War II. We are looking at other nations outstrip us in research and development and investment, infrastructure, far greater than we are, at least relative to GNP, GDP today. Now suddenly, when we're still in this very slow recovery, with major loss of jobs, the signals coming from the Fed are relative to potentially increasing interest rates.

Now I think you're too astute and I think the Fed as an institution is too astute to see the short-term rates change, at least in short order here.

But the question is whether the message is the right message at this point. The question is whether the policy ought not to be more visibly articulated as looking for expansion and for availability of credit and for encouraging people to do some of the things that they're not willing to do today.

If the message is going to be one that we're going to see a tightening on the monetary side and restraint there at the same time that we have the kind of restraint we have on the fiscal side, I do not see how we're going to see anything but more of those headlines of loss of jobs in the order of the 25,000 that we read about today.

I think that is the critical subject matter of this hearing. Senator Sarbanes and the Chairman have expressed their concerns about it. I just want to underscore that.

Mr. Chairman, I look forward to the discussion with you today on this question of the monetary response relative to these other tough choices we are making up here.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm of Texas.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, thank you for the recognition. I'm going to make a few responses to the comments that have just been made.

First of all, Republicans offered 73 amendments in the Budget Committee and on the floor of Congress to the President's budget, including two comprehensive substitutes. Each of those amendments had to do with cutting spending.

I would agree with my colleague from Massachusetts that President Reagan and President Bush did not veto enough spending bills. But I voted to sustain each and every one of those vetoes, and I do not ever remember my colleague from Massachusetts ever voting to sustain one of them.

So it's one thing to criticize Presidents for not vetoing spending bills, but the point is that we do have a problem and the problem is spending. And we're not going to deal with the spending problem by raising taxes.

It is obvious to me, Chairman Greenspan, in listening to all this discussion, that you are going to be under immense pressure to reinflate the American economy.

I don't believe for a second that you can impose the taxes contained in the Clinton economic program and not have the economy stagger under the weight of those taxes. And it is clear in listening to our colleagues here today, it's clear in listening to the administration that they plan to ask the Federal Reserve to bail them out by inflating the American economy.

We have an independent Fed to protect the American economy and the American people from just that kind of political pressure.

I think there's only one thing worse that we could do in this whole economic mess that we're about to create, and that is expand the monetary base rapidly. Try to hold interest rates down artificially low, and in the progress, you reignite inflation so that we replay the economic horrors of the 1970's.

I have absolute confidence, Mr. Chairman, that you are not going to allow that to happen. And I want you to know that you have support in Congress.

I think we need a monetary policy that is trying to promote full employment. But if the fiscal policy of the country, by imposing taxes on people who do the work, pay the taxes and pull the wagon, ends up pushing us into a situation where people are not saving, are not investing, are not creating jobs, the worst thing we could do in trying to deal with that mess would be to inflate the American economy and to overlay inflationary pressures on top of it.

I think that that would be an economic nightmare and one that probably, no matter what happens in the 1994 elections or the 1996 elections, we're not going to be able to fix easily.

So, in your hands, to a very large extent, rests the decision as to whether we make worse what I believe will be an economic downturn from this new tax and spend program, slow, sluggish growth because of the tax burden and because of wealth redistribution, and because there's no fundamental change in the spending pattern of the country. I think what you do is going to determine whether that becomes a worse economic mess. I am glad that you have the independence to exercise public policy in the public interest, and I have no doubt that you're going to do it.

Senator KERRY. Mr. Chairman, could I just, point of privilege, clarify a few things so the record is clear here?

The CHAIRMAN. Senator Kerry.

Senator KERRY. I said that there was no offering of an amendment in the Finance Committee, and that is accurate. There was nothing offered by Republicans in the Finance Committee.

On the floor, what was offered was a very generic and general, nonspecific spending reduction effort and everybody complained about the lack of specificity.

Third, the vetoes of the President that were offered by President Bush and President Reagan were not over the spending, with one exception, I believe. They were over abortion. And that is why they were vetoed, because the DC appropriations and others had abortion spending in them.

I am confident the President of the United States has sufficient ability—in fact, all this talk about a line-item veto—he basically has one today. The President doesn't want a bill because there are ten items of pork in it, the President has always had the power,

and usually has been successful, in saying to us, I'm going to veto this bill if you don't take these five items of pork out of it.

And unless there's a sufficient consensus and a sufficient broad fabric built within that legislation so that enough Senators' States and Congressmen's districts are contained in it, the President can usually have those items taken out, and because of the massive importance of the rest of the spending in the bill, we want the bill badly enough, we pass it without those items. That rarely happens. You know it and I know it. And we would be a hell of a lot better off if it did.

Senator GRAMM. Mr. Chairman, may I respond?

The CHAIRMAN. One final comment here.

Senator Gramm.

Senator GRAMM. Let me just give you a perfect example. President Reagan vetoed the highway bill because he thought the level of funding was too high. That veto was overridden.

In 1973 more amendments were offered to the tax bill, to the budget, and to the so-called economic stimulus package, there were plenty of spending cuts. The bottom line is everybody talks about spending cuts. Rarely does anybody make one.

Senator KERRY. But the problem is we've got to do this 60-vote joke around here. If we would go in there with 51 votes and just put the item up or down and live by it, I think we'd be a lot better off, Senator, and I'm willing to do that.

Let's put it all up for 51 votes and get away from this super-majority routine that even allows you to get to the vote.

Senator BENNETT. Mr. Chairman, can we hear from Chairman Greenspan.

The CHAIRMAN. I think that's a good suggestion.

[Laughter.]

I think there will be additional spending cuts and we'll all have a chance to vote on them.

We're going to make your full statement a part of the record. Chairman Greenspan, we'd like to hear from you now.

Senator KERRY. Are you going to accept any more of these invitations?

[Laughter.]

Senator MACK. You could come an hour later.

[Laughter.]

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE, WASHINGTON, DC

Mr. GREENSPAN. I know you're not quite certain I believe this, but I really appreciate being invited to the panel to discuss the Federal Reserve's semiannual monetary policy report to Congress.

[Laughter.]

Mr. Chairman, my remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer-term strategy for contributing, to the best of our abilities, to the Nation's economic well-being.

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff head winds has appeared increasingly appropriate. Doubtless the major head wind in this regard has been the combined efforts of households,

businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens.

But there have been other head winds as well. The build-down of national defense has cast a shadow over particular industries and regions of the country. Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates and has remained in the doldrums. At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions.

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in long-term interest rates as the prospects for credible Federal deficit cuts improved. From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially as well. All along the maturity spectrum, interest rates have come down to their lowest levels in 20 or 30 years, aiding the repair of balance sheets, bolstering the cash flow of borrowers, and providing support for interest-sensitive spending.

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation. As I pointed out in my February testimony to the Congress, there is a constraint that did not exist in an earlier time. Monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flair-up of inflation expectations, pushing long-term interest rates higher and short-circuiting essential balance sheet repair.

The cumulative monetary easing over the last 4 years has been very substantial. Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances.

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on average, moderate economic growth. Short-term real interest rates have been in the neighborhood of zero over the last three quarters. In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and monetary expansion. The forces that engendered past inflationary episodes appear to be have been lacking to date.

Yet, some of the readings on inflation earlier this year were disturbing. It appeared that prices might be accelerating, despite product market slack and an unemployment rate noticeably above estimates of the so-called "natural" rate of unemployment—that is the rate at which price pressures remain roughly constant. In the past, the existing degree of slack in the economy had been consistent with continuing disinflation.

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets,

but on other factors as well, including the rate at which that slack is changing. Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity. This may well have set in motion a wave of price increases which showed through to broad measures of prices earlier this year.

Moroever, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures. The University of Michigan survey of consumer attitudes, for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3¾ percent in the fourth quarter of last year to nearly 4½ percent in the latest quarter. Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be as yet persuasive. Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply in recent months. And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging.

The role of expectations in the inflation process is crucial. Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period.

The Federal Open Market Committee became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion. Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive. Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken—and indeed none occurred. But it did indicate that further signs of potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth.

Certainly, the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold. Nonetheless, on balance, the news on inflation so far this year as a whole must be characterized as disappointing.

In assessing the stance of monetary policy and likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year.

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected. Smoothing through the quarterly pattern, however, the economy appears to have accelerated gradually over the past 2 years, to maintain a pace of growth that should yield further reductions in the unemployment rate. Consequently, the evidence remains consistent with our diagnosis that the underlying forces at work are keeping the economy generally on a moderate upward track. However, as I have often emphasized, not all of the

old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward. Thus, caution in assessing the path for the economy remains appropriate.

Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now. By no means is the process over, but good progress has been made. On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of demand for our exports.

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

It seems that the prospective cuts in the deficit are having a variety of substantial economic effects well in advance of any actual change in taxes or in projected outlays. Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution to private spending plans.

To be sure, the conventional wisdom is that budget deficit reduction restrains economic growth for a time, and I suspect that is probably correct. However, over the long run, such wisdom points in the opposite direction. In fact, one can infer that recent declines in long-term interest rates are bringing forward some of these anticipated long-term gains. As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain. Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook.

Assuming, however, we constructively resolve over time the major questions about Federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades.

Over the last 2 years, the forces of restraint on the economy have changed, but real growth has continued with one sector of the economy after another taking the lead. Against this background, Federal Reserve Board Governors and Reserve Bank presidents project that the U.S. economy will remain on the moderate growth path it has been following as the expansion has progressed, and inflation will come in at or just above 3 percent this year and next.

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey-Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994. One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years—and the atypical increases in their velocities—would persist for a while longer. To an important degree, the behavior of M2 has reflected structural changes in the financial sector. Depository credit has been weak, necessitating little bidding for deposits, and depositors in any case

have been drawn to the higher returns on capital market instruments, including bonds and stock mutual funds.

In this context, the FOMC lowered the 1993 ranges for M2 and M3 to 1 to 5 percent and to 0 to 4 percent, respectively. This represents a reduction of one percentage point in the M2 range and a ½ percentage point for M3. Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges.

As I have emphasized in a similar context in February, the lowering of the ranges is purely a technical matter; it does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint.

In reading the longer-run intentions of the FOMC, the specific ranges need to be interpreted cautiously. The historical relationships between money and income, and between money and the price level have largely broken down, depriving the aggregates of much of their usefulness as guides to policy.

At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place.

In these circumstances, it is especially prudent to focus on longer-term policy guides. One important guidepost is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects.

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation—below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction. Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential.

The level of the equilibrium real rate—or more appropriately, the equilibrium term structure of real rates—cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy. Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations.

The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending. So, for example, in recent years, the appropriate real rate structure doubtless has been depressed by the head winds of balance sheet restructuring and fiscal retrenchment. Despite the uncertainties about the levels of equilibrium and actual real interest rates, rough judgments about these variables can be made and used in conjunction with other indicators in the monetary policy process. Currently, short-term rates most directly affected by the Federal Reserve are not far from zero; long-term rates, set primarily by the market, are appreciably higher, judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations. This configuration indicates that market par-

ticipants anticipate that short-term real rates will have to rise as the head winds diminish if substantial inflationary imbalances are to be avoided.

While the guides we have for policy may have changed recently, our goals have not. As I have indicated many times to this committee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living. And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability.

Inflation is counterproductive in many ways. Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals. Compounding this negative effect, under the current tax code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation. Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers.

Senator SARBANES [presiding]. Mr. Chairman, people are melting away from here, not because of anything you're saying, but because there's a vote on the floor of the Senate. We were keeping it going in the hopes to finish your statement, then we could resume the questioning when we return. But obviously, that's not going to be the case.

I think we're going to have to take just a short recess, return, and take the balance of your statement, and then go to questions. So if you'll just hold on, we'll be able to resume very shortly.

Mr. GREENSPAN. Certainly.

[Recess.]

The CHAIRMAN. Mr. Chairman, I understand that you were close to completing your statement when the committee had to recess for this rollcall vote on the Senate floor. And if that's correct, I'm going to have you resume now and make whatever closing remarks you wish.

Mr. GREENSPAN. Yes, that is correct, Mr. Chairman. I have been discussing the issue of inflation and growth of productivity.

The link between the control of inflation and the growth of productivity underscores the importance of providing a stable backdrop for the economy. Such an environment is especially important for an increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances. New firms, new products, new jobs, new industries, and new markets are continually being created and they are unceremoniously displacing the old ones. The U.S. economy is a dynamic system, always renewing itself. Central planning of the type that prevailed in post-war Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness. But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper.

Risk-taking is crucial in the process that leads to a vital and progressive economy. Indeed, it is a necessary condition for wealth cre-

ation. In a market economy, competition and innovation interact; those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind. The pace of churning differs by industry, but it is present in all. At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete. Many products that were at technology's leading edge, say 5 years ago, are virtually unsalable in today's markets. In high-tech fields, leadership can shift rapidly. In some markets where American firms were losing share just a few years ago, we have regained considerable dominance, and, more generally, it appears that the pace of dynamism has been accelerating.

The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed. But there are nonproductive and unnecessary risks as well. There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions. But many uncertainties and risks do not foster economic progress, and where feasible, should be suppressed. A crucial risk in this category is that induced by inflation. To allow a market economy to attain its potential, the unnecessary instability engendered by inflation must be quieted.

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are a key to long-run economic growth.

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before. The sensitivity of inflation expectations has been heightened and, as recent evidence suggests, businesses and households may be becoming more forward-looking with respect to fiscal policies as well.

I believe we are on our way toward re-establishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this Nation. The public, however, clearly remains to be convinced. Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist. But there are glimmers of hope that trust is re-emerging. For example, issuers have found receptive markets in recent months for 50-year bonds, and yesterday, even 100-year bonds. This had not happened in decades. The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued.

Mr. Chairman, it is my belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well positioned to remain at the forefront of the world economy well into the next century.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Chairman.

Let me refer to those 100-year bonds that you just made reference to. Those were, and are, being offered by the Walt Disney Company.

Mr. GREENSPAN. That's correct.

The CHAIRMAN. Quoting from the article in yesterday's Wall Street Journal, they say that bond traders were surprised to hear that the entertainment concern is expecting to sell $150 million of 100-year bonds at a yield of only about 7½ percent, barely 0.95 percentage points above the 30-year U.S. Treasury bonds. I can see why they would find that quite a striking circumstance. I find it that way. But then further down in the article, it says:

But demand for the issue is said to be brisk and there is even some talk that the offering size might be increased.

Mr. GREENSPAN. In fact, it was.

The CHAIRMAN. So it sounds to me as if certainly the investors in these bonds—this is 100 years into the future and at a rate that is less than a full percentage point above that of the Government rate. It sounds to me as if at least the people buying these bonds are not laying awake at night fearing a surge of inflation.

Mr. GREENSPAN. I think that's correct, Mr. Chairman. This is one of the more important indicators that the longer-term inflation expectations which have so bedeviled our economy and financial markets seem to be receding, and that's a very good sign.

The CHAIRMAN. So is that the same thing as saying, if they are receding, that we are not facing a serious inflation threat at this time?

Mr. GREENSPAN. The evidence that we have at this point certainly confirms what all of us are aware of, that the fundamentals seem to be quite subdued.

The problem that we at the Federal Reserve had and the reason for our asymmetric directive was that what we were looking at earlier this year was a surprising upturn in price indexes wholly inconsistent with all previous relationships between prices and the slack in product markets and in labor markets.

What was of increasing concern to us at that time was that it was possible, and we underline the word possible, that some new forces may have been emerging which had not had any validity in the past and which we had not observed emerging.

And what was fairly apparent as we tried to figure out why, for example, wages were rising faster than they would have in the context of the historical relationships was that there was a degree of inflation expectation embodied in both the wage side and the price side that broke the connection between the so-called fundamentals and the actual price changes. It was our view that that could possibly create a problem for us.

In the event, it turned out not to be the case, that is, as best we can judge looking at the May and especially the June data, there has been a clear simmering down of that process.

The CHAIRMAN. So, as you say, it was not the case. The concern that arose earlier in the year, later data caused you to decide that that was not the signal of some disturbing new situation.

Mr. GREENSPAN. The specific data were clearly much improved, and we'll be looking, I must say, at the next 2 or 3 months to see how they evolve to confirm that.

But there was another element involved in our asymmetric directive which is a longer-term question. It really gets down to the issue I discussed in my prepared remarks, namely, that leaving aside the question of the real prime rate which Senator Sarbanes

raised and which I will respond to when he gets back, the evidence indicates that we cannot maintain a zero real short-term rate indefinitely into the future as the economy finally unwinds from its strained balance sheets and expect that the economy will maintain a balanced long-term growth.

So the signal we were endeavoring to send is that somewhere out there, there is going to have to be a rise in real short-term rates.

This obviously can occur if, as is possible, and we would certainly hope, inflation falls further, which would, in effect, not increase current nominal short-term rates, but would make them higher in real terms or, failing that, a rise in nominal short-term rates would be required.

We don't know where or when such changes are implicit for stability purposes. We do know that if the general concept of how the economy is functioning and our diagnosis of it are essentially correct, that at some point, the economy will start to improve as the balance sheet restraints fall off. And I must say that growth, per se, doesn't necessarily engender inflationary pressures, but we have to be vigilant to make certain that that fact does not occur.

Our major concern is that we do not inadvertently fall into the experience of the late 1970's and early 1980's, when we were way behind the curve, did not anticipate the degree of inflationary expansion that was going on, and the tragic results of that, I think, are much too extraordinary for us to even conceive of facing them again.

So the signal we are endeavoring to send here is that, at some point, real rates are going to have to move up for two reasons. One, for the general overall stability, but also because of the increasing and, I think, very credible evidence that low inflation means rapid growth and productivity.

And to the extent that the central bank can contribute something to the longer-term growth of this economy, it clearly is suggested that to the extent that we can keep inflation subdued, we will maximize growth and productivity, and that is a major factor in the long-term growth of this economy and in the growth of employment and standards of living.

The CHAIRMAN. That's not the same thing, is it, as asserting that this is sort of a one-legged stool, that if you've got inflation beaten down to a deminimus level, that we can take our eye off other things.

I mean, if you have a situation where you've got widespread unemployment, declining living standards for many people, other basic problems in your economy of an absence of sufficient growth and reinvestment, can't you have other problems that can unhorse the economy, other than just—I mean, obviously, you've got to pay attention to inflation. It looks to me like the Fed pays about 99.9 percent of its time to inflation and the rest of the time to employment and growth and the other things.

Now that may be a perception that's——

Mr. GREENSPAN. I hope it's a gross exaggeration.

The CHAIRMAN. But I think more and more people are coming to feel that the tilt is so strongly on the side of people laying awake nights worrying about the inflation problem arriving—and I don't

just say this to you. Other members of the Fed, in their public comments, certainly give that impression.

Now, maybe they don't mean to or maybe that's just part of what they think or maybe their comments are being exaggerated in the press. But the bottom line of it is that we almost never hear the Fed talking very much about getting the employment levels up and the unemployment levels down.

In the conversations, inevitably, the inflation issue is usually the first issue raised, the middle issue raised, and usually the last issue raised. And then if there's a little bit dropped in around the edges about growth and recovery and rebuilding the job base, it's sort of a residual in the conversation.

I think there is that pattern that's developed. I'm a little concerned about it, quite frankly, because I see an awful lot of people finding their living standards hollowed out. A lot of people are working harder and are earning less for it.

We've had real wages for most workers in the society remain quite stagnant now over a very long period of time. I don't see them "contributing to inflation or inflationary pressure." For the moment, I'll put health care costs in a separate category because I think that has been an inflation driver, but not everybody gets health care coverage.

So that problem has got to be dealt with in and of itself. But when I look at just strict wages per hour for workers and I watch the productivity improvements as well, I find a lot of people in the society working harder, producing more, and earning less.

That to me is a real concern. It's an economic concern over and above what constitutes a fair return for work, but it also, I think, has major bearing on people's faith in the economic system and in the future and whether or not, for example, today, even with very low long-term mortgage interest rates, a person feels as if they can go out and buy a house, either for the first time or maybe trade up because their family has gotten larger and they need a larger house, but they're reluctant to do so because they don't have very much confidence in their own economic future.

And so I think there is an asymmetry in the policies, if you will, where the focus on inflation is being the driver that, in a sense, in the end, has to equilibrate everything, I think overstates and makes too simple the relationship of that one item to a far more complex economic picture.

Then when you throw in on top of that the record high unemployment rates that we're seeing in Europe today, which I'm concerned about, and I think we all ought to be concerned about, and the slack in our own economy—when I look at the areas of the economy that are going through a deflation or a water-treading process, and those areas where we see inflation, I see more deflationary areas than I see inflationary areas.

What am I missing?

Mr. GREENSPAN. First of all, let me just say that we don't look at the issue of inflation or growth as separate questions. Our concern about inflation essentially relates to our concern that if it were to reassert itself, it would stifle growth, create unemployment and induce economic contraction.

So what we're looking for is to try to find the best policy, and we obviously can only affect part of the system, that, as I said in my prepared remarks, sustains long-term economic growth.

The reason we raise issues about inflation is to make certain that the system does not put various bottlenecks in place which induce a variety of negative consequences.

Now in my testimony today, last February, and earlier, we've gone to a very extraordinary extent in trying to explain why we believe we have the type of sluggish economic growth we are involved with.

It looks increasingly the case that what we indicated was the nature of the problem that confronted us, a year or 1½ or 2 years ago, was correct. As I said back then, the best way to come to grips with strained balance sheets is to bring interest rates down gradually so that long-term rates can come down, short-term rates can come down, and we can accelerate the repair of those balance sheets, which, in my judgment, is a necessary condition for the resumption of viable economic growth, increased jobs, and a strong long-term outlook.

I don't view the issue of inflation independently of the process of creating sustained, long-term economic growth. It's part of the process. The reason why I am raising the issue more today is because, in the past, we've discussed why we were bringing rates down. Rates have now been stable since September. This is the longest time that I remember that we have been able to hold to a stable rate.

The CHAIRMAN. Is that partly due to weak loan demand?

Mr. GREENSPAN. No.

The CHAIRMAN. Well, the banks keep telling us that. The banks tell us there is weak loan demand. Virtually every single bank says that.

Now, the borrowers——

Mr. GREENSPAN. I'm not referring to short-term credit demands, I'm referring to our policy. In other words, our ability to maintain a stable policy since last September merely is the result of our judgment that that's the appropriate stance given the outcome of the economy.

The CHAIRMAN. Yes. But my point to you is if you've got continuing weak demand out there for credit that's not, in effect, taking out larger and larger loans, doesn't that help keep the interest rate down? Isn't the slack economy part of why your low interest rate process is succeeding? You've got a sick economy.

Mr. GREENSPAN. The reason why we are as low as we are is precisely because the demand for loans and other financial instruments is subdued. And indeed, the problem that we have in the longer run is in order to facilitate the repair of balance sheets, we have been forced to bring rates in real terms below what we perceive is their equilibrium.

And the only issue that I am raising with respect to the question of having to go back up at some point, and I frankly don't know when that is, is that we're going to have to restore a balance. And that will occur as we perceive that the balance sheet strain, which is the reason why we are as low as we are, is beginning to unwind. At that point, loan demand hopefully will be far more normal.

The CHAIRMAN. But with so much slack in the economy in so many areas, that doesn't necessarily mean you're going to get an inflationary surge when that happens. There's great pressure downward on wage rates and on a lot of other things. And so, I guess I want you again to identify for me, if you can, areas of the economy where you see inflationary aspects. I see deflationary aspects.

Mr. GREENSPAN. That's true. They exist.

The CHAIRMAN. Well, which ones do you see that are in the deflationary category?

Mr. GREENSPAN. I would say we still have evidence of continued either deflation or disinflation in the commercial real estate area. We had, but we seem to be in a sort of relatively flat price stability in residential real estate. There's a very slight upward movement, clearly far less than we have perceived in the past.

Capital assets related to real estate have also been generally, I would say, quite weak. And since they are a major part of our economy, that is a not irrelevant consideration. It shows up, I might add, partly in the Consumer Price Index, in the owner-equivalent rent, which is 19 percent of the total index, and which tends to reflect the market values of residential real estate. So it spills over into these other indexes as well.

The CHAIRMAN. Apart from gold, and that's in a different category. We were told that the Chinese are buying gold for reasons of their own, and that's distorting the market. I don't want to get off into a discussion on gold unless you think it's highly relevant.

Setting that aside, are there other areas where there are embedded inflationary pressures within our economy today that we really need to worry about, that are rearing their heads and where we should right now take an early warning sign? Do you see it in wages? Do you see it in energy costs? Do you see it in any of the fundamentals——

Mr. GREENSPAN. [Nods in the negative.]

The CHAIRMAN. You're shaking your head no.

Mr. GREENSPAN. I don't see them at the moment. The question is not the current state. I said that about emerging inflationary pressures after the episode earlier this year which might be explainable by the acceleration of economic activity late last year which engendered the inflationary expectations that we pick up in the various different surveys.

Excluding that, it's very difficult to find any particular area. Our concern is not with the existing state, but to keep vigilance to make certain that we do not allow elements of inflation to emerge to a point that they will create imbalances, and it's there where we are most concerned.

But you're asking factually, are there any immediate areas where those problems exist? The answer is, aside from the expectational areas, and gold would be in part in one of those, one does not find it. And obviously——

The CHAIRMAN. You don't find it?

Mr. GREENSPAN. Do not. I can find individual prices. Steel prices have gone up. We've had a lot of commodity, different commodity——

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The CHAIRMAN. But in terms of the thrust of my question, you don't see it.

Mr. GREENSPAN. I do not.

The CHAIRMAN. All right. And I appreciate that. I'm about to finish and yield to Senator Bennett.

If, on the one hand, then, you're not able to identify pockets of inflationary pressure that really concern you right now, but by the same token, you do identify pockets of deflationary activity that we're still working our way through.

When I hear that, that causes me to say that, on balance, we've got probably more deflationary activity working its way through than we do inflationary pressure.

Mr. GREENSPAN. The extent of decline that is currently going on in the areas which you've called disinflationary, when averaged against the other areas of the economy, do not produce inflationary surges or real problems, but that doesn't mean prices are stable. There are a number of areas of the economy which are rising. Health costs, for example, are still rising. They've come down from their rate of increase and that's obviously quite encouraging. But if you had an overall price index which would include both gross domestic product items and capital items, the index would still be going up, not down.

The CHAIRMAN. Well, I think you'll find out across the highways and byways of America, just in terms of how people feel, not the folks in suspenders on Wall Street and others, as important as they may be to the system, but I'm just talking about rank and file citizens across the country. They're very uneasy. All the data shows it. The most recent consumer confidence data shows it.

But these polls that show people with this great anxiety about the future, say it another way.

I would say to you, for most rank and file citizens, in terms of their balance sheets, they see deflationary pressures or they're sort of running in place.

Mr. GREENSPAN. That's basically the reason why the so-called head winds are so important, that people who have found themselves in an overborrowed state, or——

The CHAIRMAN. Or an underincome state.

Mr. GREENSPAN. Either an underincome or a falling asset state, they have been pulling back. And that's not been an insignificant element, and it is the reason why this recovery has been so extraordinarily subnormal.

The CHAIRMAN. Well, when you take somebody whose house values decline by 20 percent, and where both the husband and wife are working and now one or both are out of work, it doesn't make for a very happy outlook. And we've got more and more people in that category.

Somehow, we've got to punch up the unemployment side of this. I think the country's got to be able to feel better about its economic prospects and it's got to be more widely shared.

We just can't have—one of the things that bothers me and this may just be my philosophy—is that there are some people who are really doing awfully well in the current circumstance and there are a very large number of people who basically are sliding backward and their living standards are being hollowed out, and we're not

doing much to change that, quite frankly, other than to exchange polite commentary about it.

The public, I think, is getting very exasperated about it as measured by a lot of things.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I'd just observe that it's the people that are doing quite well that the President is calling upon to make a contribution to the deficit reduction program.

The CHAIRMAN. And properly so.

Senator SARBANES. Because it is on them that, in effect, the increased revenue burden will fall. And I think it is appropriate to do that.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Chairman—transferring the title—may I take advantage of your being here to get a little insight, and as I indicated in my opening statement, add to my own education?

We've seen a very clear demonstration in the committee here today that the number-one concern around here is deficit reduction. And we've had a lot of statements made for a lot of reasons about the best way to do that.

Coming from where I come from, I see a circumstance that strikes me as a clear win/win deficit reduction, a proposal that will bring more revenue to the Treasury and stimulus to the economy, which will produce, ultimately, more revenue to the Treasury. I'm talking about the capital gains tax rate.

As I understand it, 15 percent of something is alot more money than 28 percent of nothing. And we hold the capital gains rate at 28 percent. The Senate increased the capital gains tax rate prior to going to conference on the reconciliation bill.

I think we're going to continue to get a high percentage of nothing when we could swell the Treasury if we were to lower the capital gains tax rate. But every time anybody says that, the computers that we use to make our decisions for us around here score it differently than what I consider to be obvious common sense.

So I'm asking you, as an economist, as well as the Nation's central banker, but maybe you'll have to put your banker's hat aside and put on your economist's hat for a minute—first, am I right that a decrease in the capital gains tax burden would produce increased revenue for the Treasury, and stimulate the economy? And if I am right, why don't the computers agree?

Mr. GREENSPAN. Senator, I've said before this committee on numerous occasions that my preferred position was a zero tax on capital gains, largely because I think it's an unproductive form of taxation. So I have not been focusing very closely on the whole issue of revenues received from the tax, per se.

The reason why there are big differences in estimates is that very small changes in assumptions create very large alterations in the revenues that are received from the individual tax.

My impression is, looking at most of the standard models that create those revenues, that they're probably substantially underestimating the degree of receipts that would occur.

But I've never argued that the reason to lower the capital gains tax or index it retroactively or, in my case, preferably, eliminate it,

has had anything to do with the revenue question. It's an important element in engendering the type of risk-taking which I consider so crucial to the maintenance of an economic system.

I took special time to put in my prepared remarks here that I view the economy as a continuously churning system, renewing itself very quickly, a process which indeed seems to be accelerating. And if that is in fact the case, then for us to maintain our international and domestic competitive edge, incentives to risk-taking are essential.

As I said in my prepared remarks, a necessary condition for the creation of wealth is risk-taking because you have to devise actions to be taken in the future, and unless you do that, there's no way to create wealth.

So I would argue that, as I have numerous times before this committee, we should look at this question far more closely than we have.

Senator BENNETT. Well, I would certainly endorse a zero rate on capital gains. I understand that's the case in a number of other countries where their growth has been faster than ours. But as an interim step toward that goal, would it make some sense to, either through indexing past gains or lowering the rate, move—well, let me——

Would it make sense as an interim step toward that goal, to take some kind of reduction?

Mr. GREENSPAN. Senator, I'm not going to talk about any of the details of the existing budget discussions as I indicated when I was here 6 months ago.

Since I have discussed this at great length prior to that, obviously, I would argue in favor of retrospective indexing, mainly on the grounds that nominal capital gains are essentially the result of two components. One is the real gain and the second is the depreciation of the currency. It strikes me that if one can make the argument that one should tax the real gain, it's very difficult to make the argument that somebody should be taxed because the currency is depreciating.

And it's in that context which I think that indexing capital gains is a sensible approach, if the rate is going to be more than zero.

Senator BENNETT. I see. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sarbanes. And when I come to Senator Bond, I'm going to give Senator Bond some extra time so that he can make an opening comment.

Senator SARBANES. Mr. Chairman, I'd just point out, in light of the discussion that just took place, that even on the premises of Senator Bennett, that zero percent of something and 28 percent of nothing, work out to the same, bring you out to the same point.

Mr. Chairman, the first thing I want to do is read into the record a paragraph in your statement, of which you read only the first sentence because I think it's important that the whole possible scenario be laid out. And I'm now quoting from your statement on page 7:

Assuming, however, we constructively resolve over time the major questions about Federal budget and health care policies—and let me interject, it's an important part of the President's program, that the next step be to address the health care issue, which would of course address some of the inflation concern you expressed with re-

spect to rising health care costs since the central element of the President's proposal in that area will be health care costs containment. And that's the next step, to follow on the budget decision, and that has both important health care implications and important economic and budget implications, as I think we all recognize. And in fact, is the second piece to in effect bring the deficit down, actually to phase it out over time.

That's the remaining part of the piece of the puzzle that has to be put into place. The President is very much committed to that.

But let me just go back to your statement.

Assuming, however, we constructively resolve over time the major questions about Federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades.

The balance sheet restructuring are both financial and nonfinancial establishments in recent years, should leave the various sectors of the economy in much better shape and better able to weather untoward developments.

Similarly, the ongoing efforts by corporations to pare expenses are putting our firms and our industries in a better position to compete both within the U.S. market and globally. And after a period of some dislocation, the contraction in the defense sector ultimately will mean a freeing up of resources for more productive uses.

Finally, a creditable and effective fiscal package would promise an improved outlook for sustained lower long-term interest rates and a better environment for private sector investment.

All told, the productive capacity of the economy will doubtless be higher and its resilience greater.

Now it's my understanding that this is in effect what the President is trying to achieve. The President is trying to achieve a credible and effective fiscal package which would promise an improved outlook for sustained, lower, long-term interest rates and a better environment for private sector investment. He's concerned about enhancing the competitive ability of our firms and industries in the U.S. market and globally.

He recognizes that while there is some dislocation in the contraction in the defense sector, and we've proposed a conversion strategy to ease that dislocation and to shift those resources, those highly trained and skilled people out of defense work over into the civilian sector.

But as you say here, ultimately will mean a freeing up of resources for more productive uses. The balance sheet restructuring will strengthen various sectors of the economy.

So out of all of that, I think will come an economy healthier and more vibrant than in decades.

Now, obviously, the concern that's been expressed here, and Chairman Sasser indicated it earlier, is that, as we try to address this deficit problem that has been handed to the President, a very large proportion, we at the same time have to be concerned of how does the economy continue to move forward? And of course, we're looking there for impetus on the monetary side in order to keep this thing working.

Now let me just ask a few questions. I want to quote some of your colleagues in the field. That's sometimes the best way to get at some of these points.

Paul McCracken, only a day or two ago, in an article in The Wall Street Journal, says—and I'm quoting him now—"there is no mystery about the unsatisfactory current performance of the U.S. economy."

The problem is a basic macropolicies we have been pursuing. Our monetary policies have so limited the expansion of the money supply, that we have had a shrinking money stock in real terms. The anemic pace of the recovery from the 1990–91 recession, is not therefore surprising. You've got the economic performance that was to be expected from the policies pursued.

Now, of course, you're just departing from M2. I just want to discuss that a bit. I'm not a big monetarist and I don't know necessarily that I get its passage from the scene. But, anyhow, it's the standard that's been used and I want to just try to address it here for the moment.

The red line is the—it's actually where M2 is. These dotted lines were your previous targets, 2 percent to 6 percent.

As I understand it, the Fed has now revised the targets to these blue lines, 1 percent to 5 percent. And I'm just a little curious, I want you generally to address this quote of McCracken. I'd be interested. I'm sort of curious why you didn't revise your targets down a little further. So you could have gotten the red line up above the blue line.

[Laughter.]

If you'd have done that, if you'd come in at ½ a percent to 5 percent or even 0 to 4 percent, you would have gotten your red line, where your money supply is, in your target range.

I'm just struggling to understand why we didn't do that. I quote this story that McCracken told in a hearing we had here about these target ranges and about getting into them. And he says, and I'm now quoting him:

> Federal Reserve policy reminds me of that old story of the man who stopped for gasoline at a station, noticed many targets on a building, each with a bullet right through the bull's eye. And he said, 'My word. Who is the marksman who can hit it that way?'
>
> The station attendant said, 'Well, he's the village simpleton and he's standing right there. Ask him how he does it.'
>
> And so, he was asked. And he said, 'Why, it's very simple. I shoot and then I draw the target right around it.'

[Laughter.]

Well, you didn't quite do it here, and I just wondered why you just didn't go ahead and do it, and we'd have had this red line up above the blue line. You'd have said, we're within our target range.

Mr. GREENSPAN. The reason, Senator, is had we lowered it, you would have read me that story. And I thought I was fending that off.

[Laughter.]

But obviously, I failed.

[Laughter.]

But in all seriousness, the issue that is involved here is whether or not M2 is and has been a valid indicator of economic performance in the last 2 or 3 years. The evidence as of, say, the end of last year, would suggest that it was probably correct to assume that M2 was becoming increasingly faulty. Six months later, it's becoming extraordinarily persuasive. And what I'm saying here is that if M2 were functioning the way it had in the past, then Professor McCracken's viewpoint would be most appropriate.

But I think that M2 or the monetary aggregates have veered off so significantly, that, indeed, if the old relationships were still in

place and we actually had numbers of the type that you show on that chart, this economy would be going down in real terms.

What has happened is that what we used to relate was so-called income velocity, which is income over M2, as a function of short-term interest rates and the relationship was very close. You chart those relationships now, income velocity goes straight up as interest rates go down, or technically, opportunity costs. And it is very apparent visually that the relationship has completely broken down.

My own impression is that the reason for that is largely the balance sheet problems that we have been having and I am not at all convinced that when the balance sheets are repaired, that we will not find that M2 is back where it used to be.

In other words, I have not yet given up on M2 ultimately. I'm just saying, in this environment in recent years, because of the very special nature of what's happening to the balance sheet, that M2 is a very faulty indicator. And to use it as a measure of monetary policy is and has been inappropriate.

So, therefore, I would disagree with my old friend Paul McCracken basically on technical reasons. It rests wholly on how one evaluates the importance of the monetary aggregates. In my view, that is the basis of his evaluation and the basis of his statement.

Senator SARBANES. Mr. Chairman, my time is up. Let me just make this observation.

What you're now doing in your statement is substituting a new sort of benchmark, which is this equilibrium interest rate. I'm not sure this exercise is where we ought to be going. Why don't we simply take your unemployment projections, your growth projections, and your inflation projections and discuss those as what ought to be the goals or objectives of monetary policy? Then we can look and the Fed could say, well, we want to project this inflation rate with this unemployment rate and this growth rate.

Now, people could start asking the question, well, wait a second. That may not be the best mix. Maybe the mix ought to be a somewhat different inflation rate, a better unemployment rate, a better growth rate.

It seems to me then we're dealing with real things that actually impact very directly on people's lives and we could begin then to discuss monetary policy in the context of broader economic policy.

I apologize.

The CHAIRMAN. Well, I want to go to Senator Bond. Do you have a comment on that and we can come back to it.

Mr. GREENSPAN. I just merely wanted to indicate, Senator that obviously, we look at all of these variables. But there are other forces in the economy which move all of those key variables and you can't really make the assumption because it's not credible, that changes in monetary policy can do all of those various things.

But I certainly agree with you that, basically, there is a real world out there and that when we use things like M2 or real interest rates, these are intermediate indicators to try to, in effect, fine-tune monetary policy, if I may use that term, to the real-world conditions. That does not mean that we are not looking or shouldn't be looking at all of those real variables for obvious reasons that if

we had focused solely on M2, we would have no relationship to the real economy, as I understand it now.

The CHAIRMAN. Let's come back to that.

Senator Bond, I've asked to double the time period for you because you've been very patient. If you need more time than that, let me know.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you, Mr. Chairman. I hope to be able to stir enough trouble in the time you've generously allotted me.

I apologize. I had wanted to be here to hear the entire discussion today, but there was a mark-up in appropriations in a subcommittee on which I am the ranking member.

I welcome Chairman Greenspan. We always benefit from your economic and monetary advice. Since, apparently, we have been ranging widely over a number of areas, I would apologize if you have already dealt with some of the areas that I would like to discuss. But for my own elucidation, I wanted to get your advice on several matters.

There has been, rightly so, I think, much discussion from this side of the table about the problems with the economy and unemployment and low incomes.

I believe that perhaps too much credit is being foisted upon monetary policy, whereas, in fact, I believe that fiscal policy and proposed fiscal policy has had a very significant impact.

And I will tell you that, anecdotally, as I have talked to people in business in my State and I've had a lot of time recently to talk with many people in my State, mostly looking at the floods, I have heard businesses, businessmen and women, small businesses and large businesses, saying, we are scared to death of the tax package that you are about to foist on us and the possible burdens that new taxes or new mandates of health care would put on us. And as a result, we can't afford to make the decision to hire new people.

A small manufacturer of marble fixtures in the Springfield, Missouri, area told me that they had put off plans for a 50,000-foot expansion that would hire six more people because they felt that these taxes and the burdens would make it unprofitable.

I've read recently in the summary of reports from the regional Fed Banks, that in the St. Louis area, the decline in business confidence and consumer confidence was cited as a result of the pending tax bill, plus the prospects of health care reform, as being one of the impediments to economic growth in the area.

I note that you said on page 6 that expectations of a significant credible decline in the budget deficit have induced lower long-term interest rates. But the positive influence is apparently at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

In addition—skipping down a couple of lines—uncertainty about the outlook for health care reform may be affecting spending, at least by that industry.

This is the long way of getting around to a question.

As I read the report, the day before yesterday, in The New York Times, it seemed to imply that the Fed Chairman was saying that

we must approve the specific plan for a deficit reduction of $500 billion over 5 years.

As I have understood your testimony, you have not stated that we need all these taxes. You have stated that we need to get our fiscal house in order. Am I closer to the truth or is the previous source which I mentioned closer to the truth?

Mr. GREENSPAN. First, as I've indicated here in February and repeated several times before the Congress, a credible—underline credible—budget deficit reduction, in my judgment, is crucial to the long-term health of this economy. There are a lot of important effects, including lower long-term interest rates.

Second, I have eschewed getting involved in the details of the composition of the budget. I have hopefully stayed away from being supportive of any particular vehicle that has come before the Congress, whether it be the President's or other initiatives that have come before either house of the Congress.

I nonetheless indicated that I think there are certain principles involved in how one comes at the problem. The major issue—I think it was quoted by your colleague from Florida very much earlier—is that, under current law, expenditures are growing faster than the tax base after defense expenditures bottom out in the latter part of the 1990's.

And it is clearly the case that unless we bring expenditure growth back down to the growth of the tax base, we will not be able to fundamentally solve the long-term burgeoning budget deficit problem. But aside from that and a few other related arithmetical questions relevant to budget deficit reduction, I've tried to stay away from either commenting on any particular initiative, including the President's.

Senator BOND. But I do take it from your comments that you feel a credible plan has to deal with the entitlement, the increase in entitlements or mandated spending that we see taking the deficit back up again, even if the Congress were to adopt and the President to sign the tax increase package that is now in conference.

Mr. GREENSPAN. Yes. As I indicated to the House Banking Subcommittee on Tuesday, and actually here in February, the particular packages that are being discussed, even the $500 billion package, does not address fully the upturn in the deficit as a percent of the gross domestic product in the latter part of the decade and into the early part of the next century.

The problem that we have got is, arithmetically, that the excess above the growth of the tax base is in Medicare and Medicaid, and if one can bring those budget items into line with the growth of the GDP in nominal terms, then that will be adequate to bring the expenditure level down.

However, if reform is unable to bend this very rapidly growing share of Medicare and Medicaid as a percent of the GDP from growing rapidly to being flat, meaning it still continues up, then we'll be required to address other areas of the budget at the turn of the century to make sure that total expenditures do not rise faster than the tax base because that's an unsustainable position.

Senator BOND. I would agree with you. And while we would like to have your public support for the package that Senator Dole and Senator Domenici introduced to eliminate the budget deficit by cut-

ting spending, we realize you are not doing that, but we also appreciate very much having on the record that you are not endorsing the taxation plan put forth by the President or passed by the Senate.

I would note also that while we throw around the figures, $500 billion, everybody knows that $500 billion is smoke and mirrors and there are elements which we've already enacted into law. They're credit for interest savings. And the real tax cuts are a significant portion, the spending cuts—tax increases are a significant portion. The spending cuts do not occur until 1997 and 1998.

I also wanted to comment on the question of—I guess it's the ultimate in static analysis.

Our colleague from Utah, Senator Bennett, said 28 percent of nothing is nothing. My good friend from Maryland said, zero percent of a whole lot, I think he said, is equivalent to the same thing. And that's the way I think the joint tax evaluates things like capital gains reductions because if you had zero capital gains or if you've cut capital gains to 15 percent, setting aside the capital gains tax revenues, would not the added incentive for risk-taking, the freeing up of capital, provide economic growth and jobs that would in fact add revenues to the Treasury, absent any of the revenues from capital gains?

Mr. GREENSPAN. Senator, that's always been my position and the reason why I've argued that the effective rate on capital gains is best at zero.

Senator BOND. Mr. Chairman, I appreciate that very much. I just want to ask one quick question on the administration's Community Development Bank bill.

The Community Development Financial Institutions would be, in a sense, competing with regular financial institutions. Would that have an impact on the CRA obligations of banks who are competing with these Community Development Banks? And I apologize, but I just wanted to get this on the record.

Mr. GREENSPAN. Yes. I don't think that that has as yet been fully resolved by the administration. We'll have to await the specific recommendations that will be coming from the Treasury and from the Comptroller of the Currency.

Senator BOND. Thank you, sir.

The CHAIRMAN. Thank you very much.

Senator Sasser, chairman of the Budget Committee.

Senator SASSER. Thank you very much, Mr. Chairman.

Dr. Greenspan, in your prepared remarks, which I read very carefully prior to this meeting here today, and then listened to you deliver, you point out that the drop in long-term interest rates following the aggressive deficit reduction program that the administration is now presently pursuing, that the drop in long-term interest rates have had a positive effect on the economy. You indicate that in your statement.

But you also indicate in your statement, and this is disturbing, that it's being offset at least partly by the effect of pending tax increases. Specifically, you say that business is reducing their spending in anticipation of some of the tax increases.

Now, there has been a very aggressive and unrelenting campaign—we saw some of it here today—mounted to convince Amer-

ican business and individuals that their taxes are going to go through the roof.

I know of one poll run by a very reputable polling organization that indicates that over one-half of the people, over 50 percent of the people in this country think their income taxes are going to go up, when, in fact, income tax rates are being increased on less than 2 percent of the population. Less than 2 percent of the population are going to have their income tax rates go up.

Now on the business side of the ledger, this aggressive campaign to misinform has gotten so out of hand, that The Wall Street Journal—of all publications, a highly respected publication, has had two articles to dispel the view that small business is going to be smitten an economic death blow by these taxes.

They've got an article here entitled, headlined: "Foes of Clinton's Tax Boost Proposals Mislead the Public and Firms on the Small Business Aspects." They go ahead to indicate in the graph here that with regard to small business taxpayers, only 4.3 percent are going to see their taxes go up and a substantial percentage are going to see their taxes go down.

Senator SARBANES. Would the Senator yield on that very point?

Senator SASSER. I'd be pleased to.

Senator SARBANES. In this very article, they had a small business owner who came in at a news conference to complain about the higher taxes. It turns out here taxes are not going to go up, not going to go up at all under the Clinton program. In fact, they may go down because there's some write-offs for small business that are provided in the Clinton program and some other incentives for small business. So a lot of small business people are in fact going to end up paying lower taxes.

Now the Treasury doesn't dispute the fact that well-off small business owners will pay higher income taxes, just as will well-off bankers, orthodontists, and Exxon Corporation executives. But only about 4 percent of those taxpayers who report some business income on their tax returns, and that includes partners in law firms and investment banks, make sufficient money to be hit by the higher tax rates—4 percent.

And we're hearing this drumbeat that the taxes of small business are going to go up. Four percent will go up and the taxes for a lot of the others will go down because of the other small business features of the Clinton economic program.

Senator SASSER. Well, I couldn't agree more. And this propaganda effort is one of the most impressive I've seen. I think Joseph Goebbels, if he was still around, would envy the effectiveness of this propaganda campaign that's been unleashed across this country to misinform the American people about the magnitude of these increases.

Now my question to you, Mr. Chairman, to the extent that the American people have been mislead, and to the extent that businesses have been mislead in anticipation of these taxes, is this not having a dampening effect on economic activity?

Don't you think that the perceived impact of these taxes is infinitely greater or much greater than the impact the actual proposals under consideration will have?

Mr. GREENSPAN. We don't have evidence to make that judgment. The only reason that we know that this phenomenon exists is we pick it up anecdotally in our various surveys. We are picking up a fairly broad amount of it.

But we have no way of knowing other than articles such as you quote whether the individuals who are taking economic actions are correctly or incorrectly evaluating what the potential tax would be under the President's program.

Senator SARBANES. But it is plausible—if you're finding that you think economic activity is being impacted by the expectation of this measure, that if they are being given false expectations about what the measure would do, that economic activity is then being falsely inhibited, as it were, because people would then be acting because they have a mistaken notion of what's coming. That's quite plausible, is it not?

Mr. GREENSPAN. The issue that I'm raising is I don't know the extent to which people are misunderstanding the nature of the bill.

Senator SARBANES. Right. Well, clearly, from this story, a number of people are doing exactly that. A lot of small business people think they're going to be hit by this thing, and now it's being explained to them that they're not going to be hit at all.

Senator SASSER. Mr. Chairman, my time is expired. But could you yield me some more time in view of the fact that Senator Sarbanes——

The Chairman. By all means.

[Laughter.]

I will yield you——

Senator SARBANES. Take that from my next round.

[Laughter.]

The CHAIRMAN. —more time.

Senator SASSER. I thank Senator Sarbanes for making these points. They are very valid points and they are points that need to be made.

I might say, anecdotally, to reinforce what you inferred that you were picking up, as I go around my State, I have these—let everybody know I'm going to be in a certain place at a certain time. I'm going to be in the courthouse in Lebanon, Tennessee, at 12 noon. Anybody wants to come talk to me about something, they can come there.

I'm being flooded by small business people coming in there, irate, think their taxes are going to be raised through the roof. You sit down and explain the proposal to them. First, there's disbelief because of what they've been picking up, newsletters that have been mailed to them by small business organizations, grossly misinforming them.

Then when you finally convince them that their taxes are not going to be raised or, indeed, they may go down, there's a sense of enormous relief. So, anecdotally, I can testify to the fact that it's out there. And I think it is having a chilling effect on business activity at a certain level, as you have indicated.

Now, Dr. Greenspan, we do see long-term rates coming down and that's a matter of great satisfaction to all of us and I'm certain it's a matter of great satisfaction to you and your colleagues at the Fed

because you have long advocated policies that would bring down long-term rates.

There are some here who would like to derail this deficit reduction endeavor that we're all engaged in, or most of us, or a majority of us are engaged in.

If those who wish to derail this deficit reduction effort are successful, let's just say in the next 2 weeks we can't pass the reconciliation, the budget reconciliation conference report in their house.

In your judgment, what would be the reaction of the financial markets to just a meltdown, and what would be the effect on the economy?

Mr. GREENSPAN. As I indicated to a similar question in the House the other day, it's clearly negative, Senator. I don't know the order of magnitude or the dimensions, but the best I can judge, there is built into the current long-term interest rate level an expectation that however this process evolves, at the end of it is a credible budget deficit reduction, or one at least that materially alters the path. If that view is frustrated, I would suspect that rates would work their way back up with clear negative consequences.

Senator SASSER. I think it's very important that someone of your stature and prestige make that statement and that that be known across the country and it be known here in this body, and in the other house, that it is of crucial importance to the economy and to long-term rates that we pass a package here that produces credible deficit reduction.

One final short question, Mr. Chairman.

The CHAIRMAN. Could I just ask one thing related to that, if Senator Kerry will be patient with me?

As I understand that exchange, I take it that it would be your view that the financial markets now, in sort of helping to set the interest rate environment that we now see out there, are anticipating that a deficit reduction effort will be put in place that is very close to the $500 billion that is on the table. That is now currently essentially the basic market expectation, is it not?

Mr. GREENSPAN. I would say that the markets believe that some credible budget deficit program, without specifying what the composition would be because I don't think you can tell that, will be enacted.

The implication of veering off the standard of the $500 billion, in my judgment, is clearly one which the markets would take quite negatively.

The CHAIRMAN. Yes. Now, but related to that, if this process were to hit the wall here and collapse at the present time—I mean, the current timetable is to have this done within the next 2 weeks. If that should not happen, if we should hit an impasse and this thing goes into limbo, I would think that would create a real shock to the financial markets, wouldn't it?

Mr. GREENSPAN. If it's not clear that the process is still functioning and is still likely to come up with a credible reduction at the end of the day, then, yes, the answer is it would have quite a negative impact.

The CHAIRMAN. Thank you. Thank you, Senator Sasser. Now you had one more thing you wanted to bring up.

Senator SASSER. One quick question because I'm impinging on my friend, Senator Kerry, here.

Dr. Greenspan, I want to read a short paragraph from The Wall Street Journal article. You'd think I was selling subscriptions to The Wall Street Journal here today, but——

[Laughter.]

Senator SARBANES. This is a news article, not an editorial, I take it.

Senator SASSER. It is a news article. That's correct.

Dr. Greenspan, I want to read a short paragraph from The Wall Street Journal article regarding your testimony before the House Banking Committee, and then ask you a question about it. The Wall Street Journal reporter quotes you as saying:

> With unemployment still high, factories operating far from full capacity, and international competition stiff, Mr. Greenspan made clear that the Fed doesn't see any reason for inflation to get worse.
>
> But he said that the Fed should respond to fears of inflation, even if unjustified.

Now, I have some difficulty in following that logic because if we respond to unjustified fears, don't we run the risk, really, of validating those fears?

Would we be better advised to work diligently to dispel those unjustified fears and not fuel them? And I'm concerned about a substantial downside risk to responding to a phantom inflation out there.

Mr. GREENSPAN. That is a shortcut of a statement I actually had in my presentation today, in which I was reflecting the fact that even inflation expectations which are unfounded could have significant effects.

For example, if there was a general, broad and inappropriate expectation of inflation on the part of a number of people in a wage-bargaining stance and they, as a consequence, created a much higher wage rate increase than would otherwise be the case, that would feed into the system and could have a life of its own.

Now I was not saying that we should respond to that. I was merely indicating that that is the context in which monetary policy must function. Whether one responds or not really depends on whether or not you think it's a bubble, whether you think responding will have any effect.

But I would certainly not argue that one would automatically respond to such a thing for exactly the reasons that you suggest.

Senator SARBANES. Would I be irrational if I were a labor negotiator at the bargaining table and someone said, well, look at this. The Open Market Committee has shifted from a neutral policy to an asymmetrical policy and they expect to perhaps raise interest rates. The reason they expect to do that is they think there's going to be an inflation problem.

And I say, ah ha. The Fed thinks there's going to be an inflation problem. I'd better take that into account here at the bargaining table as I try to negotiate my wage package. Consequently, the Fed in effect helps to feed the inflation prospect instead of where I might otherwise say, well, the Fed doesn't think there's going to be inflation. They've got a kind of a neutral policy. I'm not going to push you now on lowering the rates, but they've got a neutral pol-

icy and therefore, I don't have to build that into my bargaining expectations.

Mr. GREENSPAN. No, I think it's the other way around, actually. If they perceive that we are vigilant and would suppress inflation when it emerged, then my real wage increase does not have to be augmented by an inflation premium.

But even having said that, just let me say that an asymmetric directive is not an indication that we expect inflation to accelerate. The purpose of that, as I indicated when I think you were out of the room, is essentially in the event that it occurs. But we're not projecting that it indeed will be the case.

Senator SARBANES. Well, it's Senator Kerry's turn. Both Kaufman and Samuelson, I'll come back to it in the next round, address this very point and the answer you've just given. And it was their conclusion to the contrary, that in fact, rather than dampening inflationary expectations, it may well contribute to that.

Mr. GREENSPAN. I must say I find no evidence to support that view.

Senator SASSER. I'll defer to Senator Kerry. He has some charts.

The CHAIRMAN. Senator Kerry.

Senator KERRY. They're probably your charts.

[Laughter.]

Mr. Chairman, I want to pick up from where both Senator Sarbanes and Senator Sasser have been in this discussion, particularly with the view to a paragraph on page 4, your third paragraph in your testimony.

You asked the question, why, for example, despite an above-normal rate of unemployment and permanent lay-offs, have uncertainties about job security not led to further moderation in wage increases?

The answer that you offer us is the "deep-seated anticipations understandably harbored by workers that inflation is likely to reaccelerate in the near-term and undercut their real wages."

Now, again, I don't know many labor bargainers, nor do I know many workers who have expressed any fear whatsoever to me or to anyone that they are about to have their wages undercut by inflation. I'd like to show you a couple of charts that seem to contradict that notion.

Here are the real average hourly earnings of Americans from 1980 and this is their descent up until 1993. This is what's happened to the American worker.

Now that was not because of inflation in 1980 that that happened. It's because of the recession. It's because of the transition in our economy. It's because of the lack of investment. The diminishment in productivity. It's a whole bunch of things. But certainly, no American is going to sit there and say, inflation has hurt my prospects in the last 10 years.

Moreover, real median family income in America, Mr. Chairman, I don't think you would suggest that between 1940 and 1967, the rate of increase was too low, would you? It was a rate of increase of 2.8 percent.

Mr. GREENSPAN. 1947.

Senator KERRY. 1947 to 1967. From 1967 to 1973, it went down to 2.6 percent to 2.8 percent a year. From 1973 to 1979, it was 0.6

percent. From 1979 to 1989, that 10 years during which the wages went down, here's what happened to family income—0.4 percent increase.

And Mr. Chairman, 1989, 1990, and through now, it's decreasing. That's what's happening to the wages of Americans, family income of Americans.

Now you add to that the prospect of what's happening to the work force, 1960–65, we had 25 percent of the work force with low wages in America. And thanks to investment, thanks to growth in the economy, that came down, until 1980. And in 1980, at the same time as you have a diminishment in American wages, a diminishment in the hourly wage, a diminishment in the family income, you have a very significant increase in the percentage of American workers between the ages of 18 and 34 who are in low-wage jobs and an increase in all workers in low-wage jobs.

Now I don't hear any of them, and none of these statistics support the notion that they're sitting around saying, oh, my God, inflation is going to undercut me. They're trying to catch up.

I really ask you to share with us what the meaning of these statistics is against their current predicament in the work place and this marginal evidence, which, incidentally, was contradicted by the May and June figures, I believe. It's not there.

Mr. GREENSPAN. Let me tell you exactly where that paragraph is coming from. When we look at wage changes relative to various measures of slack in the labor market, we find that the actual change in wage compensation levels, in fact, is running somewhat higher than past historical relationships would have suggested.

The question that we ask, why would that be so? What is a potential hypothesis? And this is one hypothesis which comes from the University of Michigan survey of consumer attitudes in which the question that is asked is what is your expectation of inflation over the next year?

And as I cited in the paragraph just previous to this one, the expectation was for a rise from the fourth quarter of last year a year forward of 3¾ percent inflation, and this increased to 4½ percent in the second quarter.

So what I'm saying is how can we explain the fact that historical relationships have veered off?

This is one potential explanation. Whether it's the only one, I don't know. But the fact of the matter is we do have difficulty trying in our models and evaluations to explain why the rate of increase in compensation per hour is at the somewhat elevated level that it is relative to where those models would have expected it to be.

Senator KERRY. When you offer to us as a rational for a discussion about a tighter monetary policy and the potential of raising interest rates and sending the message that both Senator Sarbanes and Senator Sasser have heralded as potentially having a countereffect. Yet, you have not a focus group or a poll in which you ask a question of an American, do you think inflation may set in, given the experience of the 1970's and given the general perceptions of Washington, given the lack of success we've had in dealing with the budget deficit. But I don't believe that is what is driving any bar-

gaining at the table or driving the fundamental insecurity that the American worker has.

That security is driven and, in fact, their reaction to taxes is not properly derived from an increase in taxes in America. Indeed, we have gone from 70 percent down to 28 percent, and 33 percent for some in the bubble. We've had the greatest reduction in the tax burden in the history of this Nation. Yet, Americans think they're overtaxed.

What you and others have not really addressed, I think, and aren't addressing in this current predicament, is what those charts show, which is really what Americans are indicating.

They can't pay for things because their wages are not buying as much. They're working harder and less able to make ends meet. And they're taking it out on taxes because that's the one horribly evident place from which their money gets taken from them unwillingly, but it is not in fact the problem, as increasingly, people are beginning to see.

Domestic discretionary spending has gone down as a proportion of gross domestic product since the 1960's. We were spending 15 point some percent back then. Now we're at 11 point some percent. What has gone up, we all know, are entitlements and interest on the debt.

I think when you suggest here that the wage-earners—that inflation might come and there's a reason and the reason is that, as you have put it, the answer appears to lie at least in part in the deep-seated anticipations of workers that inflation is going to reaccelerate, I just think you're wrong, Mr. Chairman.

The CHAIRMAN. Just before you respond, might I just add one point to this because I think this sort of gets to the heart of a debate that we've been having here for some period of time.

I think the Fed has a great focus on balance sheets and John Kerry's talking about what's happening on the income statement. And those are the two documents that matter. If you have assets, if you're in a situation where you've accumulated assets, you may have more focus on the balance sheet, in some respects, than you do on the income statement.

If you're somebody that works for a living and hasn't accumulated very much and your living standard is going backward and you're not able to earn very much because your wages are dropping or because your spouse in the family has lost their second job, it's a job and it's the income side that you really have to focus on.

And I think, unfortunately, there's an elitism that's gotten embedded in our policy where we think much more about what's happening to the person who's got a large accumulation of assets and how they feel about inflation than we do about the question of this hollowing out of the job base of the country, and that more and more people can't earn a decent living.

I don't know how we get them into the equation. But I don't think they've been put into the equation and I think your charts are absolutely on the money.

I thank you for yielding.

Mr. GREENSPAN. I must disagree, seriously. The issue that we're raising here in this paragraph is a very narrow statistical question.

If you're asking me am I aware of the elements that are involved in the labor markets, the very great difficulties that have emerged, the issue of temporary employment, the insecurities that are involved, all of the various things that we pick up in all of these various surveys, let me say to you that I am acutely aware of that and process that all the time.

We look at the questions of the income distribution effect that Senator Kerry was raising and these are crucial aspects of the way the American economy is evolving.

The issue that is addressed here is a very narrow statistical question that gets to the point that the inflation in the early part of the year, which I must say occurred at higher levels both in compensation and in prices than past history would have indicated, requires that we ask ourselves why? What is there different about the current period than in past years? And all I am saying is, what evidence we have—and I grant you, it may not be conclusive—does suggest that individuals who are reporting to the University of Michigan survey—and it's the best source of data that we have—indicate a rate of inflation expectation which is greater than one would ordinarily expect coming out of our evaluations.

I'm saying that what we're raising here or what I'm putting in the text is an endeavor to explain an analytical phenomenon. We are surely not insensitive to questions that you raise and indeed, I'm quite familiar with the data.

Senator KERRY. Well, did it occur to you or does it occur to you that the average American or anybody answering that kind of survey would lump under the concept of inflation because they don't have an understanding of all these other things happening, all these other things?

Mr. GREENSPAN. Yes, of course.

Senator KERRY. But that doesn't mean that that should be expressed as a rationale for your policy because you know better.

Mr. GREENSPAN. No, it's not—this is not an issue of our policy. This is an analytical question of endeavoring to try to understand why the——

Senator KERRY. The very next sentence says, "The Federal Open Market Committee became concerned that inflation expectations and price pressures, unless contained, could raise long-term"——

Mr. GREENSPAN. That's correct.

Senator KERRY. This is the rationale.

Mr. GREENSPAN. No, no. But it's the overall expectations question generally. Now observe that what we're trying to say is the only explanation that we could surface as to why these data were behaving the way they were was this break between the fundamentals, on the one hand, and prices, wages, and other elements on the other.

The only thing that's in the middle is psychology. And so we're asking the question, is it credible that what we are dealing with is an inflation psychology issue?

Senator KERRY. I understand that.

Mr. GREENSPAN. And that's the reason why the——

Senator KERRY. My time is expired. I truly do understand that. But what you are saying on this page, and what you've said in the preceding page in the preceding paragraph—the role of expecta-

tions in the inflation process is crucial. And as Senator Sarbanes and Senator Sasser said, you're reacting to this possibility, to the fear.

Mr. GREENSPAN. If certain events occur to create not only an inflation psychology, but real inflation as a consequence, then we might—and I underline the word might—have to react because if we don't, then we are risking an upturn in long-term interest rates and a decline in the economy.

Senator KERRY. I understand. But there is such a thing as deflation, is there not? There is such a thing as deflation.

Mr. GREENSPAN. Of course.

Senator KERRY. And what I have shown you are curves that show deflation. The minute you turn around from the deflation, in a sense, and come back to a level of equilibrium, the fact that you've gone up to get there doesn't mean you're in an inflation cycle.

Mr. GREENSPAN. I agree with that.

Senator KERRY. But you're beginning to treat it and your statistics treat it as if you are.

Senator SARBANES. That's right.

Senator KERRY. So you automatically react right away and say, oh, my God, we've got to maybe contract and send the message that interest rates may go up and everybody says, uh oh, that's going to condition a whole set of behavior.

What we're trying to say to you, Mr. Chairman, very respectfully, because I know you're better at this than I am and you know more about it than I do, but just from my common sense and lay person's approach, I am deeply concerned that that kind of foundation for your approach is not taking into account thoroughly what has really happened out there in the last 10 years and what is.

Also, the global aspect of it, which we haven't even—I haven't, certainly—touched on with you. Clearly, we can't impact that from a fiscal approach. And the interrelationship is so significant, John Keynes said that there's an inevitability to a capitalist system ultimately providing more supply than demand. That's what we've got in the world now. How do you kick in the demand?

Well, if we're contracting fiscally, and we're cutting as we are, and we're going to raise a little tax, that's not so good for the demand side. So where are you left?

It seems to me that you're left on the monetary side. And if the monetary side is talking about suddenly holding back the brakes or putting on the brakes, we've got a big problem, I think.

Mr. Chairman, thank you for the extra time.

The CHAIRMAN. I want to make sure you've had the time you feel you need because others have taken time. So if you need more time, we'll certainly accommodate you.

Senator KERRY. No. I appreciate it. I'm late for everything I have to do.

The CHAIRMAN. All right. Very good.

Senator Sarbanes.

Senator KERRY. I appreciate it.

Senator SARBANES. Well, Mr. Chairman, I want to commend Senator Kerry because I think he's really pursued a very important line of questioning. I want to follow up with it. And I want to do

it by making reference to the testimony we received only a few weeks ago from Henry Kaufman, who is regarded as a distinguished analyst of economic conditions. I want to suggest very respectfully to the Chairman that there is a quite reasonable and rational body of opinion that is taking issue with the Fed, at least up to a point.

At the outsides of this debate, I don't think there's a difference. But in the middle of it, there's some difference and that's important because we're in a very critical stage with respect to the economy.

We're going to try to do a major deficit reduction program which you've sat at the table and told us is absolutely necessary. We are coming to grips with issues that have been ducked for a long time. It's being done in a very balanced way and it involves a lot of tough decisions, contrary to the drumbeat in here today about no spending cuts. That's not correct.

In fact, this package has more spending cuts in it than it has tax increases. But it's an effort to put the two together in order to have a very significant, credible deficit reduction program.

But for it to work to reduce the deficit, let alone provide jobs and economic growth, the economy has to keep moving. And if we're going to constrain fiscal policy, the only place we can find to get economic movement in the economy is from an accommodating monetary policy.

Now Kaufman said, and I'm going to quote him, not at great length, but at some length because I want to get this thinking out and give the Chairman a chance to respond to it. He says:

I believe that in the global context that I have described, the Federal Reserve should be able to pursue these joint objectives for at least the time being by maintaining the present degree of monetary accommodation.

The joint objectives he's talking about are sustained economic expansion and continuing downward pressure on the rate of inflation. He thinks those joint can be accomplished with the present degree of monetary accommodation.

It may also find the opportunity of taking advantage of the coming global deescalation in interest rates to edge the Federal funds rate somewhat lower, particularly if the U.S. dollar continues to display the kind of strength in the foreign exchange markets that it has in recent days.

Then he goes on to say:

What I do not favor is a preemptive move toward restraint on the pretext that this would somehow shore up the Federal Reserve's credibility in the financial markets and in so doing, relax market concerns about inflation prospects.

I have great doubts about conditioning policy on something as ill-defined as the notion of credibility. It is a policy argument that has an unfortunate tone of self-righteousness rather than a firm analytical grounding. As a policy position, it is especially bizarre at the present time when, if anything, the financial markets have shown themselves to be quite comfortable with the overall stance of monetary policy.

He says:

I also reject the proposition that a modest rise in the level of the Federal funds rate would have little significance for the economy, and so that such a preemptive move by the Federal Reserve would be costless. To the contrary, a higher Federal funds rate would translate into higher interest payments by businesses and households, specifically those with adjustable rate mortgages, a higher dollar in the foreign exchange markets, and some downward pressure on share prices.

All would weaken growth prospects.

And then, finally:

I also take issue with the assertion that a small increase in the Federal funds rate this summer would be welcomed by the financial markets and would accordingly lead to a decline in bond yields. Perhaps. But equally likely is that the bond market would interpret such a rise in the Federal funds rate as the first of a number of future increases and market participants might easily react by pushing bond yields higher.

Maybe such a preemptive move would reassure the financial markets that the Central Bank was determined to quell inflation, and so would reduce inflationary expectations. But it is equally likely that the market would suspect that the Federal Reserve was in possession of information not yet publicly disclosed, indicating the upcoming new inflation news was going to be sour. Under that scenario, the rise in the Federal funds rate could magnify inflationary expectations, precipitating a sell-off of bonds.

Then we get the story the day after you testify earlier in the week, "Long Rates Soar as Aftershock of Greenspan's Speech Takes Toll on Bonds."

Mr. GREENSPAN. What's the source of that?

Senator SARBANES. The American Banker.

Mr. GREENSPAN. Because, you know, I looked at the rates. Long-term rates actually, as I recall, didn't they go down or were unchanged, essentially unchanged from the time when my presentation was made to the end of the day?

Senator SARBANES. I'll read you the article. The article may be inaccurate, and if so, I'm happy to be corrected.

Long-term interest rates surged Wednesday, a belated reaction to Federal Reserve Board Chairman Alan Greenspan's inflation alarm of the day before. Market analysts said concern about upcoming sales of Treasury securities and heavy issuance of competing long-term debt by corporations also exerted pressure.

I want to lay it all out here.

In late trading, the price of the Government's 30-year bond fell ⅞ths of a point, raising the yield——

Mr. GREENSPAN. No, that was yesterday. In other words, is that today's paper?

Senator SARBANES. This is July 22.

Mr. GREENSPAN. Yes. Let me——

Senator SARBANES. That's today's paper and it's about what happened yesterday. You testified on Tuesday.

Mr. GREENSPAN. Yes, but——

Senator SARBANES. Let me just finish the quote and then I'd be happy for you——

Mr. GREENSPAN. Sure.

Senator SARBANES. And they then go on to indicate the changes that took place. The Wall Street Journal says:

Bond Prices Plunge on Wave of New Issuance. Concerns About Fed's Policy on Interest Rates. Also contributing to the plunge were concerns about the Federal Reserve's policy toward interest rates in the wake of Fed Chairman Alan Greenspan's comments to the House Banking Committee on Tuesday.

Mr. GREENSPAN. I'm reading The Wall Street Journal here and it basically says:

Yesterday, the bond market was assailed on several fronts. Analysts said traders knocked prices of long-term bonds lower on fears that the Clinton administration's deficit reduction plans may hit some snags.

This is page C–1 of today's Wall Street Journal.

I will say this——

Senator SARBANES. I want to find the page from which this article comes and I'll give that to you shortly.

Mr. GREENSPAN. That would be helpful. The Wall Street Journal, I presume, would be saying the same thing in the same place.

Senator SARBANES. Well, we've got to read our Journal very carefully here.

[Laughter.]

This article, as I said, "Bond Prices Plunge on Wave of New Issuance, Concerns About Fed's Policy on Interest Rates."

Mr. GREENSPAN. That's today's paper?

Senator SARBANES. Yes, page C–21, Wall Street Journal, Thursday, July 22.

Mr. GREENSPAN. I think they ought to perhaps talk to each other.

[Laughter.]

Senator SARBANES. Yesterday's paper, July 21, on page C–1, says:

> Stock and bond prices tumbled after Mr. Greenspan told the House Banking Committee that although inflation moderated in May and June, overall inflation news had been disappointing because of increases earlier in the year. Bond traders drove the price of the Treasury benchmark 30-year issue down more than half a point, et cetera.

That's Wednesday, July 21, page C–1. The other article is Thursday, July 22, page C–21.

Mr. GREENSPAN. And I will say that it immediately recovered. What happened was that bond dealers were selling, but the retail trade obviously came in and bought. At the end of the day, the bond market was unchanged.

But the truth of the matter is here we're all guessing——

Senator SARBANES. I thought the bond market was down—at the end of yesterday, it was unchanged?

Mr. GREENSPAN. Unchanged. At the close of business on Tuesday——

Senator SARBANES. How about yesterday?

Mr. GREENSPAN. Yesterday, the bond market was down about 7⁄8ths of a point.

Senator SARBANES. OK. Sometimes it takes time for your—I don't quite know how to describe them.

[Laughter.]

For your comments to sort of make their way through.

Mr. GREENSPAN. Perhaps I'd better speak more quickly.

[Laughter.]

Senator SARBANES. These articles are here and we quoted one another the relevant pages. But what about the basic argument that Kaufman's making, Kaufman and Samuelson made?

Mr. GREENSPAN. Yes.

Senator SARBANES. It seemed to me to be an argument with a good deal of merit to it.

Mr. GREENSPAN. First of all, let me say, I don't know where this concept of a "preemptive strike" comes from. That's not monetary policy. I don't understand it.

If he's raising the questions about rates, there are occasions when short-term rates go up and long-term rates go up, and sometimes short-term rates go up and long-term rates go down, that's a factually correct statement. Indeed, I would say most of what you quoted from Henry Kaufman I happen to agree with, with respect to an evaluation of what is going on.

We probably disagree on the question of his basic notion of monetary policy with respect to the international coordination. But it's an arguable case.

It is a potential policy instrument, policy initiative directed at a specific type of problem. One may argue that one should do it or one should not do it. But those are very technical questions and I can't say to you I can argue strenuously on either side. It's a debatable question.

Indeed, we debate these issues all the time. And I don't want to subscribe to everything that Henry Kaufman said. There are some things I do disagree with. But as the general rule, I think he's talking the same language we all talk.

Senator SARBANES. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just finish today, Chairman Greenspan, by saying you've been very patient, as you always are, and we appreciate that and we appreciate the way in which you're willing to engage us in serious discussion here.

Obviously, the participation by Members today is another illustration that you've seen times before about the fact that we care very deeply about these issues. We want to try to reach some meeting of the minds, to the extent that that is possible, given the fact that we have oversight here and you function in an independent capacity.

I want to just finish with this point. I don't want to be misunderstood on what I said before because my point about the focus on the balance sheet versus the income statement was not directed and anchored narrowly on that one technical point.

I think there is a built-in, long-term bias in our economic policy at the top of our Government and I think it's true at the Fed, to care more about balance sheets than to care about income statements, and to care more about people who hold assets than those that are struggling to try to acquire some assets and pay the bills. Now, you may not like that characterization——

Mr. GREENSPAN. No. I hope it's not true.

The CHAIRMAN. Well, I hope it's not true, too. But it sure tends to feel and look that way. And especially in light of the data that's accumulated both prior to your watch, the long-term, gut-level data in terms of how the economy is functioning for real people and real families who never get their name in the paper versus how it works as you come on up the income and asset scale.

And we all know that policy around here tends to get driven by who has the power and who has the influence and it's nothing new. We've seen it over a long period of time.

I hear all this talk about preparing balance sheets, and we've done a lot of work here with you to write law to prepare bank sheets and other balance sheets in every way we can. I think we've made a lot of progress in that area.

You've got a terrible problem with income statements for rank and file people in the country, and I don't see much sign that that's on the Fed's radar screen. It may be in some amorphous, sort of broad level way. But in terms of really articulating it and driving policy to make sure that income, job-producing income is making its way to a large number of people in the country, the full employment side of the charge, and I don't mean people who are counted

as employed who work 1 hour a week, as our data now allows them to be counted as employed if they work 1 hour a week. But people who are in fact work and not working sliding down a real income curve such as John Kerry had a minute ago.

That's why I think you're seeing so much disillusionment in the society. It's not so much a matter of people feeling that their asset base is washing out from under them, although there is some drop in residential rates and so forth. It is that their earning prospects in the future for themselves and their children are looking mighty bleak.

I mentioned earlier today the student coming out of the University of Michigan with a straight 4.0 and all of the good extracurricular activities, the family sacrificing, the student working their way through school, coming out unable to find a job, move back in with dad and mom. Pretty disillusioning. And that is more and more the story of what's going on out there.

Somehow or another, we've got to get more job growth going. I'm not saying that is the responsibility of the Federal Reserve Board alone or even your overwhelming responsibility. But I have to tell you that I see too little emphasis in that area, in deference to a concern of other sorts. We've got to have more people at work earning incomes here in America, not in Mexico or Japan or Timbuktu, but in this country.

We don't have a very good policy mix in place to get that to happen. It's very difficult because there are a whole lot of factors at work at the same time.

I would like to see a Federal Reserve Board and Federal Reserve Board leadership, not just from you, but from the others, that are asking themselves the question, how do we get a real surge in job growth and real income growth for people in America, people who have very modest balance sheets or no balance sheets, but who we would like to have after 5 years or 10 years have a balance sheet where they can not only pay their bills for their family and their health care costs, but to accumulate some money in a 401(k) or retirement account and have some prospect of having a decent retirement.

That is receding from more and more people in this country at the present time, and it's a source of great anxiety and anguish to people that they are in that circumstance. And it's relatively new. We did not experience that in the rush after the end of World War II. But as we've gotten into the 1980's and now into the 1990's, that is more and more the story for a growing number of people in this country no matter how hard they work or how much they prepare themselves to go out and work.

I talk about the new graduates. I've got workers in Michigan with 10 or 20 or 30 years of seniority, every bit as talented and smart as any of us in this room today, who are now thrown out of the work force and cannot find comparable work and have been pushed down the wage scale and are compressed down toward the minimum wage scale of living. It's very, very destructive to our country and to our future and to them.

That is part of what's coming back through that University of Michigan data. The University of Michigan data is reflecting a de-

teriorating sense of well-being about the economic future for themselves and for their kids.

We've got to do something that finally works its way back through to the job side. I'd like to almost have another hearing where we didn't talk for 1 minute on inflation and we talked for maybe 3 hours about what it takes to get a significant spurt in job growth in America and how the Fed sees that happening, and how you're planning for it, and how your policies are designed to cause that to happen and what your employment growth goals are in Federal Reserve policy, and how we move ourselves to a point of full employment, how we get the unemployment rate below 6 percent and without the phantom counting of people who, in a sense, are working part-time or a fraction of the week who end up being recorded as employed, when, in fact, they're not employed.

So that's part of the tension I think we all witnessed in the last election. The fact that Clinton got 43 percent and Perot got 19 percent and the incumbent administration got the relatively modest amount that was left, I think was principally rooted in this economic anxiety.

Somehow out of this, we've got to come up with a formulation that gets job growth going again here in America. We need American jobs. We need a lot of them and we need them at higher income levels. If the Fed can help us get that going for just the part that you can play, you will have done a tremendous service to this country.

Senator SARBANES. Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. I just want to add to what Chairman Riegle has said.

In your own statement, the Fed is expecting unemployment to edge lower to around 6¾ percent by the end of this year, and to perhaps a shade lower by the end of next year. That's your own sort of working premise on unemployment.

Now obviously, we think that's inadequate. We're very concerned by that.

Mr. GREENSPAN. I would say that so do we.

Senator SARBANES. Let me finish. For this year as a whole, FOMC participants see inflation at or just above 3 percent and most of them have about the same forecast for next year.

Now I would submit to you, Mr. Chairman, with this kind of expectation on the unemployment rate and this kind of expectation on the inflation rate, the FOMC's current monetary policy ought not to be asymmetrical in the direction of tightening interest rates, tilting toward higher short-term interest rates.

I know you didn't act off the May 18 directive, as it were, but, nevertheless, that represented the tilt. It would seem to me—I frankly think you should tilt in the other direction. But, at a minimum, it seems to me, in the light of these expectations, on the unemployment rate and the growth figure to which the unemployment rate is related, and your expectations on inflation, the policy ought to be symmetrical. Because I would read these figures and say to myself, well, you know, we constantly worry about inflation. I don't want to minimize that.

But looking at these figures, I'd have to say that the more pressing problem—both problems are always there. But with these figures, the more pressing problem is how to bring this unemployment rate down. And obviously, if we constrain fiscal policy, our only recourse, in a sense, is to get a monetary policy that helps to provide some economic activity.

I think that's why Senator Riegle is saying there's a perception that there's a disconnect between the thinking of the Fed in its board rooms and sort of what's happening to the ordinary American out on the street in terms of jobs.

I don't say you're not concerned about it. I certainly think you're concerned about it, you personally. And I would hope that that exists within the Fed system, although I think there are some people within the system who don't recognize the unemployment as a reasonable goal and think their only goal is the price level and want a zero inflation rate. That's their working premise.

But it seems to me, given where we are now, given your own projections here, it really calls for—I don't know what you did at the July meetings because we don't know those results. But I don't think that a current tilt toward higher interest rates is warranted under the economic circumstances.

The CHAIRMAN. We now have, Chairman Greenspan, more people on food stamps in America than we've ever had in our history, just to give you one very powerful statistic as to what's going on out there where people live and are trying to get by each day.

The other day, and I'll finish with this, the other day I went back to my old neighborhood on the east side of Flint, Michigan where I grew up. It is on the industrial east side where everybody worked in the Buick auto plants. And on the corner of Franklin and Dakota Avenue, five houses down from where I spent the first 20 years of my life, in a street full of small, bungalow houses, there is a 24-hour-a-day laundromat on that corner. And as I saw it and thought about it, it dawned on me that the reason it's there is that many, many people in the neighborhood now can't afford to have their own washing machines where they live.

We pretty much all had washing machines, the old Maytag kind with the roller to wring out the water 40 years ago when I was growing up in that neighborhood. But today, a larger and larger number of people in that neighborhood can't afford something as basic as a washing machine. So they're going down to the corner and dropping their quarters in to wash their clothes in a 24-hour-day laundromat.

To me, it was a very powerful illustration of the fact that we're sliding backward. Now I grant you, that is a tiny, microfact. But we could stay here for the next 5 months and I could fill in the picture with other illustrations that are as powerful as that, like the food stamp rolls today.

So I would ask you to take the message back to some of the other people on the Fed who probably aren't having difficulty finding jobs for their kids, if their kids are of employment age, and who may be up on an economic plateau where all-night laundromats in neighborhoods like I'm describing in Flint are very far removed from what they might otherwise see or know.

We've got to have more jobs in this country and there is an obligation for everybody on that board to care about it and to have that factor in, every bit as much as any other single element, whether it be inflation-fighting or any other one item that anybody wants to talk about.

The people are waiting for that. They're expecting that. Even though you folks are not elected directly by the public, there is an accountability factor there and I hope everybody around that table understands it. I think you do. And so, I'm not making the comment to suggest otherwise. But I have less confidence when it comes to the rest of the crowd.

Thank you very much.

On the vote on the nomination of Alan S. Blinder, to be a member of the Council of Economic Advisers, the Clerk will call the roll.

The CLERK. The Chairman.

The CHAIRMAN. Aye.

The CLERK. Mr. Sarbanes.

Senator SARBANES. Aye.

The CLERK. Mr. Dodd.

Senator DODD. (Aye, by proxy.)

The CLERK. Mr. Sasser.

Senator SASSER. Aye.

The CLERK. Mr. Shelby.

Senator SHELBY. (Aye, by proxy.)

The CLERK. Mr. Kerry.

Senator KERRY. Aye.

The CLERK. Mr. Bryan.

Senator BRYAN. (Aye, by proxy.)

The CLERK. Mrs. Boxer.

Senator BOXER. Aye.

The CLERK. Mr. Campbell.

Senator CAMPBELL. (Aye, by proxy.)

The CLERK. Ms. Moseley-Braun.

Senator MOSELEY-BRAUN. (Aye, by proxy.)

The CLERK. Mrs. Murray.

Senator MURRAY. (Aye, by proxy.)

The CLERK. Mr. D'Amato.

Senator D'AMATO. Aye.

The CLERK. Mr. Gramm.

Senator GRAMM. Aye.

The CLERK. Mr. Bond.

Senator BOND. Aye.

The CLERK. Mr. Mack.

Senator MACK. Aye.

The CLERK. Mr. Faircloth.

Senator FAIRCLOTH. Aye.

The CLERK. Mr. Bennett.

Senator BENNETT. Aye.

The CLERK. Mr. Roth.

Senator ROTH. Aye.

The CLERK. Mr. Domenici.

Senator DOMENICI. (Aye, by proxy.)

The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.

The CHAIRMAN. Very good. Next, we will vote on the nomination of Joseph E. Stiglitz, to be a member of the Council of Economic Advisers.

The Clerk will call the roll.

The CLERK. The Chairman.

The CHAIRMAN. Aye.

The CLERK. Mr. Sarbanes.

Senator SARBANES. Aye.

The CLERK. Mr. Dodd.

Senator DODD. (Aye, by proxy.)

The CLERK. Mr. Sasser.

Senator SASSER. Aye.

The CLERK. Mr. Shelby.

Senator SHELBY. (Aye, by proxy.)

The CLERK. Mr. Kerry.

Senator KERRY. Aye.

The CLERK. Mr. Bryan.

Senator BRYAN. (Aye, by proxy.)

The CLERK. Mrs. Boxer.

Senator BOXER. Aye.

The CLERK. Mr. Campbell.

Senator CAMPBELL. (Aye, by proxy.)

The CLERK. Ms. Moseley-Braun.

Senator MOSELEY-BRAUN. (Aye, by proxy.)

The CLERK. Mrs. Murray.

Senator MURRAY. (Aye, by proxy.)

The CLERK. Mr. D'Amato.

Senator D'AMATO. Aye.

The CLERK. Mr. Gramm.

Senator GRAMM. Aye.

The CLERK. Mr. Bond.

Senator BOND. Aye.

The CLERK. Mr. Mack.

Senator MACK. Aye.

The CLERK. Mr. Faircloth.

Senator FAIRCLOTH. Aye.

The CLERK. Mr. Bennett.

Senator BENNETT. Aye.

The CLERK. Mr. Roth.

Senator ROTH. Aye.

The CLERK. Mr. Domenici.

Senator DOMENICI. (Aye, by proxy.)

The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.

The CHAIRMAN. Next, we will vote on the nomination of Arthur Levitt, Jr., to be chairman of the Securities and Exchange Commission.

The Clerk will call the roll.

The CLERK. The Chairman.

The CHAIRMAN. Aye.

The CLERK. Mr. Sarbanes.

Senator SARBANES. Aye.

The CLERK. Mr. Dodd.

Senator DODD. (Aye, by proxy.)

The CLERK. Mr. Sasser.
Senator SASSER. Aye.
The CLERK. Mr. Shelby.
Senator SHELBY. (Aye, by proxy.)
The CLERK. Mr. Kerry.
Senator KERRY. Aye.
The CLERK. Mr. Bryan.
Senator BRYAN. (Aye, by proxy.)
The CLERK. Mrs. Boxer.
Senator BOXER. Aye.
The CLERK. Mr. Campbell.
Senator CAMPBELL. (Aye, by proxy.)
The CLERK. Ms. Moseley-Braun.
Senator MOSELEY-BRAUN. (Aye, by proxy.)
The CLERK. Mrs. Murray.
Senator MURRAY. (Aye, by proxy.)
The CLERK. Mr. D'Amato.
Senator D'AMATO. Aye.
The CLERK. Mr. Gramm.
Senator GRAMM. Aye.
The CLERK. Mr. Bond.
Senator BOND. Aye.
The CLERK. Mr. Mack.
Senator MACK. Aye.
The CLERK. Mr. Faircloth.
Senator FAIRCLOTH. Aye.
The CLERK. Mr. Bennett.
Senator BENNETT. Aye.
The CLERK. Mr. Roth.
Senator ROTH. Aye.
The CLERK. Mr. Domenici.
Senator DOMENICI. (Aye, by proxy.)
The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.
The CHAIRMAN. Very good. Next, we will vote on the nomination of Richard Scott Carnell, to be assistant secretary of the Treasury for Financial Institutions.
The Clerk will call the roll.
The CLERK. The Chairman.
The CHAIRMAN. Aye.
The CLERK. Mr. Sarbanes.
Senator SARBANES. Aye.
The CLERK. Mr. Dodd.
Senator DODD. (Aye, by proxy.)
The CLERK. Mr. Sasser.
Senator SASSER. Aye.
The CLERK. Mr. Shelby.
Senator SHELBY. (Aye, by proxy.)
The CLERK. Mr. Kerry.
Senator KERRY. Aye.
The CLERK. Mr. Bryan.
Senator BRYAN. (Aye, by proxy.)
The CLERK. Mrs. Boxer.
Senator BOXER. Aye.

The CLERK. Mr. Campbell.
Senator CAMPBELL. (Aye, by proxy.)
The CLERK. Ms. Moseley-Braun.
Senator MOSELEY-BRAUN. (Aye, by proxy.)
The CLERK. Mrs. Murray.
Senator MURRAY. (Aye, by proxy.)
The CLERK. Mr. D'Amato.
Senator D'AMATO. Aye.
The CLERK. Mr. Gramm.
Senator GRAMM. Aye.
The CLERK. Mr. Bond.
Senator BOND. Aye.
The CLERK. Mr. Mack.
Senator MACK. Aye.
The CLERK. Mr. Faircloth.
Senator FAIRCLOTH. Aye.
The CLERK. Mr. Bennett.
Senator BENNETT. Aye.
The CLERK. Mr. Roth.
Senator ROTH. Aye.
The CLERK. Mr. Domenici.
Senator DOMENICI. (Aye, by proxy.)
The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.
The CHAIRMAN. Very good. Next, we will vote on the nomination of Susan Gaffney, to be inspector general of the Department of Housing and Urban Development.
The Clerk will call the roll.
The CLERK. The Chairman.
The CHAIRMAN. Aye.
The CLERK. Mr. Sarbanes.
Senator SARBANES. Aye.
The CLERK. Mr. Dodd.
Senator DODD. (Aye, by proxy.)
The CLERK. Mr. Sasser.
Senator SASSER. Aye.
The CLERK. Mr. Shelby.
Senator SHELBY. (Aye, by proxy.)
The CLERK. Mr. Kerry.
Senator KERRY. Aye.
The CLERK. Mr. Bryan.
Senator BRYAN. (Aye, by proxy.)
The CLERK. Mrs. Boxer.
Senator BOXER. Aye.
The CLERK. Mr. Campbell.
Senator CAMPBELL. (Aye, by proxy.)
The CLERK. Ms. Moseley-Braun.
Senator MOSELEY-BRAUN. (Aye, by proxy.)
The CLERK. Mrs. Murray.
Senator MURRAY. (Aye, by proxy.)
The CLERK. Mr. D'Amato.
Senator D'AMATO. Aye.
The CLERK. Mr. Gramm.
Senator GRAMM. Aye.

The CLERK. Mr. Bond.
Senator BOND. Aye.
The CLERK. Mr. Mack.
Senator MACK. Aye.
The CLERK. Mr. Faircloth.
Senator FAIRCLOTH. Aye.
The CLERK. Mr. Bennett.
Senator BENNETT. Aye.
The CLERK. Mr. Roth.
Senator ROTH. Aye.
The CLERK. Mr. Domenici.
Senator DOMENICI. (Aye, by proxy.)
The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.
The CHAIRMAN. And finally, we will vote on the nomination of G. Edward DeSeve, to be the chief financial officer of the Department of Housing and Urban Development.
The Clerk will call the roll.
The CLERK. The Chairman.
The CHAIRMAN. Aye.
The CLERK. Mr. Sarbanes.
Senator SARBANES. Aye.
The CLERK. Mr. Dodd.
Senator DODD. (Aye, by proxy.)
The CLERK. Mr. Sasser.
Senator SASSER. Aye.
The CLERK. Mr. Shelby.
Senator SHELBY. (Aye, by proxy.)
The CLERK. Mr. Kerry.
Senator KERRY. Aye.
The CLERK. Mr. Bryan.
Senator BRYAN. (Aye, by proxy.)
The CLERK. Mrs. Boxer.
Senator BOXER. Aye.
The CLERK. Mr. Campbell.
Senator CAMPBELL. (Aye, by proxy.)
The CLERK. Ms. Moseley-Braun.
Senator MOSELEY-BRAUN. (Aye, by proxy.)
The CLERK. Mrs. Murray.
Senator MURRAY. (Aye, by proxy.)
The CLERK. Mr. D'Amato.
Senator D'AMATO. Aye.
The CLERK. Mr. Gramm.
Senator GRAMM. Aye.
The CLERK. Mr. Bond.
Senator BOND. Aye.
The CLERK. Mr. Mack.
Senator MACK. Aye.
The CLERK. Mr. Faircloth.
Senator FAIRCLOTH. Aye.
The CLERK. Mr. Bennett.
Senator BENNETT. Aye.
The CLERK. Mr. Roth.
Senator ROTH. Aye.

The CLERK. Mr. Domenici.
Senator DOMENICI. (Aye, by proxy.)
The CLERK. The vote is unanimous, Mr. Chairman. Nineteen ayes.
The CHAIRMAN. Let me just say before we adjourn, I'd like to announce for the record that all six of the nominations pending before the committee today have been ordered favorably reported to the Senate by unanimous votes, and those nominations will be filed in the Senate this afternoon.
The committee stands in recess.
[Whereupon, at 1:47 p.m., the committee was recessed.]
[Prepared statement, Monetary Policy Report to Congress, and response to written questions follow:]

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

This morning the Committee welcomes Alan Greenspan, Chairman of the Federal Reserve Board, to testify on the Federal Reserve's plans and objectives for monetary policy. No issue the Committee deals with is more important than policies to improve the condition of our economy. And no Government policies have a larger impact on the economy than monetary policy.

The President has made economic policy his top priority, and polls show it is the top priority of the American people. Right now, in Congress, we are working hard to put the President's program into action. But it will be impossible to achieve the goals of that program, including especially the creation of 8 million jobs over the next 4 years, without the cooperation of the Federal Reserve.

The Fed's monetary policy report, released Tuesday, raises in my mind some questions about that. The Fed's decisionmakers believe that, despite the economy's continuing weakness, their policies will produce economic growth in 1993 and 1994 at only about the economy's trend rate of growth. Consistent with that, they expect little improvement in the unemployment rate, which they expect will be near 6¾ percent throughout next year, possibly slightly lower by the end of the year. So more than 3½ years after this anemic recovery began, the unemployment rate would be just ½ percentage point lower than it was at the recession's worst point.

As I read the report, the Fed is saying that is the best we can do. Even with these plodding growth rates, the Fed's projections show inflation edging up this year and next. The clear implication is that any faster growth would lead to higher inflation. That is a very important and troubling conclusion. If it's correct, it pushes off indefinitely the time when Americans can enjoy what we have come to think of as a healthy economy. And it makes the achievement of the goal for 8 million new jobs doubtful. I hope you are wrong. But before you act on this judgment, I'd like to better understand what it is based on.

Your own report says, "The fundamentals remain consistent with additional disinflation." That means you would normally expect that, in an economy as weak as ours is now, inflation would tend to decrease. And when we look at what is actually going on in the economy, we see that commodity prices measured by the Journal of Commerce Index, have gone down 5 percent in the past 4 months; we see oil prices down more than 20 percent over the past year; we see the producer price index increasing at a rate of less than 2½ percent so far this year; and we see virtually no change in consumer prices in the past 2 months. Capacity utilization is low; wage increases are small. Even despite the 2 bad months earlier this year for the CPI, the CPI's inflation rate has still averaged no worse than last year. None of our witnesses earlier this month, neither Nobel laureate Paul Samuelson, financial market expert Henry Kaufman, nor Council of Economic Advisers nominees Alan Blinder and Joseph Stiglitz, saw any evidence that there was significant risk of a near-term acceleration of inflation.

Of greater concern to me is the risk that we may not even get the growth the Fed is anticipating. Despite the lowest mortgage rates in 20 years, housing starts remain below last December's rate. The Fed's industrial production index declined last month after no growth the previous month. Increasingly weak foreign economies and budget cutbacks in defense have kept other sectors of the economy down. Instead of fearing higher inflation from excessive growth, I wonder why the Fed is not concentrating on ensuring growth adequate to guarantee new jobs and reduce unemployment.

TESTIMONY BY ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 22, 1993

Thank you for this opportunity to discuss the Federal Reserve's semiannual monetary policy report to the Congress. My remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer-term strategy for contributing, to the best of our abilities, to the Nation's economic well-being.

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff head winds has appeared increasingly appropriate. Doubtless the major head wind in this regard has been the combined efforts of households, businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens.

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But there have been other head winds as well. The build-down of national defense has cast a shadow over particular industries and regions of the country. Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates and has remained in the doldrums. At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions. These efforts have been prompted in part by innovative technologies, which have been applied to almost every area of economic endeavor, and have boosted investment. However, their effect on jobs and wages through much of the expansion also has made households more cautious spenders.

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in longer-term interest rates as the prospects for credible Federal deficit cuts improved. From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially, too. All along the maturity spectrum, interest rates have come down to their lowest levels in twenty or thirty years, aiding the repair of balance sheets, bolstering the cash flow of borrowers, and providing support for interest-sensitive spending.

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation. As I pointed out in my February testimony to the Congress, this is a constraint that did not exist in an earlier time. Before the late 1970's, financial market participants and others apparently believed that, while inflationary pressures might surface from time to time, the institutional structure of the U.S. economy simply would not permit sustained inflation. But as inflation and, consequently, long-term interest rates soared into the double digits at the end of the 1970's, investors became painfully aware that they had underestimated the economy's potential for inflation. As a result, monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flare-up of inflation expectations, pushing long-term interest rates higher, and short-circuiting essential balance sheet repair.

The cumulative monetary easing over the last four years has been very substantial. Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances.

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on average, moderate economic growth. Short-term real interest rates have been in the neighborhood of zero over the last three quarters. In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and money expansion. The forces that engendered past inflationary episodes appear to have been lacking to date.

Yet some of the readings on inflation earlier this year were disturbing. It appeared that prices might be accelerating despite product market slack and an unemployment rate noticeably above estimates of the so-called "natural" rate of unemployment—that is, the rate at which price pressures remain roughly constant. In the past, the existing degree of slack in the economy had been consistent with continuing disinflation.

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets, but on other factors as well, including the rate at which that slack is changing. If the economy is growing rapidly, inflation pressures can arise, even in the face of excess capacity, as temporary bottlenecks emerge and as workers and producers raise wages and prices in anticipation of continued strengthening in demand. Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity. This may well have set in motion a wave of price increases, which showed through to broad measures of prices earlier this year.

Moreover, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures. The University of Michigan survey of consumer attitudes, for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3¾ percent in the fourth quarter of last year to nearly 4½ percent in the second quarter. Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be persuasive. Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply

in recent months. And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging.

The role of expectations in the inflation process is crucial. Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period, potentially derailing the economy from its growth track.

Why, for example, despite an above-normal rate of unemployment and permanent layoffs, have uncertainties about job security not led to further moderation in wage increases? The answer appears to lie at least in part in the deep-seated anticipations understandably harbored by workers that inflation is likely to reaccelerate in the near term and undercut their real wages.

The Federal Open Market Committee (FOMC) became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion. Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive. Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken—and indeed none occurred. But it did indicate that further signs of a potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth.

Certainly the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold. Nonetheless, on balance, the news on inflation this year must be characterized as disappointing. Despite disinflationary forces and continued slack, the rate of inflation has at best stabilized, rather than easing further as past relationships would have suggested.

In assessing the stance of monetary policy and the likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year. This downshift left considerable remaining slack in the economy and promised that the adverse price movements prompted by the acceleration in growth late last year likely would diminish.

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected. A surprisingly precipitous drop in defense spending, a sharp deterioration in net exports, a major blizzard, and some inevitable retrenchment by consumers converged to yield only meager gains in output in the first quarter. But growth apparently picked up in the second quarter, and nearly one million net new jobs were created over the first half. Smoothing through the quarterly pattern, the economy appears to have accelerated gradually over the past two years, to maintain a pace of growth that should yield further reductions in the unemployment rate. Consequently, the evidence remains consistent with our diagnosis that the underlying forces at work are keeping the economy generally on a moderate upward track. However, as I have often emphasized, not all the old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward. Thus, caution in assessing the path for the economy remains appropriate.

Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now. By no means is the process over, but good progress has been made. Debt service burdens, eased by lower interest rates and lower debt-equity ratios, have fallen substantially in both the business and household sectors. On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of demand for our exports.

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

It seems that the *prospective* cuts in the deficit are having a variety of substantial economic effects, well in advance of any *actual* change in taxes or in projected outlays. Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans. In addition, uncertainty about the outlook for health care reform may be affecting spending at least by that industry.

To be sure, the conventional wisdom is that budget deficit reduction restrains economic growth for a time, and I suspect that probably is correct. However, over the long run, such wisdom points in the opposite direction. In fact, one can infer that recent declines in long-term interest rates are bringing forward some of these antici-

pated long-term gains. As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain. Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook.

Assuming, however, we constructively resolve over time the major questions about Federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades. The balance sheet restructuring of both financial and nonfinancial establishments in recent years should leave the various sectors of the economy in much better shape and better able to weather untoward developments. Similarly, the ongoing efforts by corporations to pare expenses are putting our firms and our industries in a better position to compete both within the U.S. market and globally. And after a period of some dislocation, the contraction in the defense sector ultimately will mean a freeing up of resources for more productive uses. Finally, a credible and effective fiscal package would promise an improved outlook for sustained lower long-term interest rates and a better environment for private sector investment. All told, the productive capacity of the economy will doubtless be higher, and its resilience greater.

Over the last two years, the forces of restraint on the economy have changed, but real growth has continued, with one sector of the economy after another taking the lead. Against this background, Federal Reserve Board governors and Reserve Bank presidents project that the U.S. economy will remain on the moderate growth path it has been following as the expansion has progressed. Their forecasts for real GDP average around 2½ percent from the fourth quarter of 1992 to the fourth quarter of 1993, and cluster around 2½ to 3¼ percent over the four quarters of 1994. Reflecting this moderate rise and the outlook for labor productivity, unemployment is generally expected to edge lower, to around 6¾ percent by the end of this year, and to perhaps a shade lower by the end of next year. For this year as a whole, FOMC participants see inflation at or just above 3 percent, and most of them have about the same forecast for next year.

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey-Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994. One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years—and the atypical increases in their velocities—would persist for a while longer. M2 has been far weaker than income and interest rates would predict. Indeed, if the historical relationships between M2 and nominal income had remained intact, the behavior of M2 in recent years would have been consistent with an economy in severe contraction. To an important degree, the behavior of M2 has reflected structural changes in the financial sector: The thrift industry has downsized by necessity, and commercial banks have pulled back as well, largely reflecting the burgeoning loan losses that followed the lax lending of earlier years. With depository credit weak, there has been little bidding for deposits, and depositors in any case have been drawn to the higher returns on capital market instruments. Inflows to bond and stock mutual funds have reached record levels, and, to the extent that these inflows have come at the expense of growth in deposits or money market mutual funds, the broad monetary aggregates have been depressed.

In this context, the FOMC lowered the 1993 ranges for M2 and M3—to 1 to 5 percent and 0 to 4 percent, respectively. This represents a reduction of 1 percentage point in the M2 range and ½ percentage point for M3. Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges.

As I emphasized in a similar context in February, the lowering of the ranges is purely a technical matter; it does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint. It is indicative merely of the state of our knowledge about the factors depressing the growth of the aggregates relative to spending, of the course of the aggregates to date, and of the likelihood of various outcomes through the end of the year. While the lowering of the range reflects our judgment that shifts out of M2 will persist, the upper end of the revised range allows for a resumption of more normal behavior or even some unwinding of M2 shortfalls. The FOMC also lowered the 1993 range for debt of the domestic nonfinancial sectors, by ½ percentage point, to 4 to 8 percent. The debt aggregate is likely to come in comfortably within its new range, as it continues growing about in line with nominal GDP. The new ranges for growth of money and debt in 1993 were carried over on a preliminary basis into 1994.

In reading the longer-run intentions of the FOMC, the specific ranges need to be interpreted cautiously. The historical relationships between money and income, and between money and the price level have largely broken down, depriving the aggregates of much of their usefulness as guides to policy. At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place.

At one time, M2 was useful both to guide Federal Reserve policy and to communicate the thrust of monetary policy to others. Even then, however, a wide range of data was routinely evaluated to assure ourselves that M2 was capturing the important elements in the financial system that would affect the economy. The FOMC never single-mindedly adhered to a narrow path for M2, but persistent and sizable deviations of that aggregate from expectations were a warning sign that policy and the economy might not be interacting in a way that would produce the desired results. The so-called "P-star" model, developed in the late 1980's, embodied a long-run relationship between M2 and prices that could anchor policy over extended periods of time. But that long-run relationship also seems to have broken down with the persistent rise in M2 velocity.

M2 and P-star may reemerge as reliable indicators of income and prices once the yield curve has returned to a more normal configuration, borrowers' balance sheets have been restored and traditional credit demands resume, savers have adjusted to the enhanced availability of alternative investments, and depositories finally reach a comfortable size relative to their capital and earnings. In the meantime, the process of probing a variety of data to ascertain underlying economic and financial conditions has become even more essential to formulating sound monetary policy. This general approach obviously has its weaknesses. When examining many indicators, some can always be found that counsel against actions that later appear to have been necessary.

In these circumstances, it is especially prudent to focus on longer-term policy guides. One important guidepost is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects.

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation—below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction. Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential.

The level of the equilibrium real rate—or more appropriately the equilibrium term structure of real rates—cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy. Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations. The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending. So, for example, in recent years the appropriate real rate structure doubtless has been depressed by the head winds of balance sheet restructuring and fiscal retrenchment. Despite the uncertainties about the levels of equilibrium and actual real interest rates, rough judgments about these variables can be made and used in conjunction with other indicators in the monetary policy process. Currently, short-term real rates, most directly affected by the Federal Reserve, are not far from zero; long-term rates, set primarily by the market, are appreciably higher; judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations. This configuration indicates that market participants anticipate that short-term real rates will have to rise as the head winds diminish, if substantial inflationary imbalances are to be avoided.

While the guides we have for policy may have changed recently, our goals have not. As I have indicated many times to this Committee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living. And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability.

Inflation is counterproductive in many ways. Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals. Compounding this negative effect, under the current tax code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation. Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can

accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers.

The link between the control of inflation and the growth of, productivity underscores the importance of providing a stable backdrop for the economy. Such an environment is especially important for an increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances. New firms, new products, new jobs, new industries, and new markets are continually being created, and they are unceremoniously displacing the old ones. The U.S. economy is a dynamic system, always renewing itself. It is extraordinary that the system overall is as stable as it is, considering the persistent process of change in the structure of our economy. For example, a frequently cited figure is the two million new jobs that have been created since the end of 1991. This is a net change, however, which masks the many millions who found, lost, and changed jobs over the same period. Currently, people are being hired at a pace of approximately 400,000 per week, with job losses running modestly below that figure. Such vast churning in the Nation's labor markets is a normal and ultimately a productive process.

Central planning of the type that prevailed in post-war Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness. But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper. Central planning fostered stasis: In many respects, the eastern-bloc economies marched in place for more than four decades.

Risk-taking is crucial in the process that leads to a vital and progressive economy. Indeed, it is a necessary condition for wealth creation. In a market economy, competition and innovation interact: those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind. The pace of churning differs by industry, but it is present in all. At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete. Many products that were at technology's leading edge, say five years ago, are virtually unsalable in today's markets. In high-tech fields, leadership can shift rapidly. In some markets where American firms were losing share just a few years ago, we have regained considerable dominance. In one case, U.S. firms have seized a commanding lead in just two years in the new laptop computer market, and now account for more than 60 percent of U.S. sales last year, triple the figure for Japanese firms.

More generally, it appears that the pace of dynamism has been accelerating. As one indication, the average economic life expectancy of new capital equipment has been falling. The average life of equipment purchased in 1982, for example, was 16½ years. By 1992 that figure had declined to 14½ years, a drop more than twice as large as that over the preceding decade. In addition, telecommunications technology is obviously quickening the decision-making process in both financial and product markets.

In such a rapidly changing marketplace, the agile survive by being flexible. One aspect of this flexibility has been the spread of "just-in-time" inventory controls at manufacturing firms. Partly as a result of innovations in inventory control techniques, the variability of inventories relative to total output appears to be on a downtrend.

The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed. But there are nonproductive and unnecessary risks as well. There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions. But many uncertainties and risks do not foster economic progress, and where feasible should be suppressed. A crucial risk in this category is that induced by inflation. To allow a market economy to attain its potential, the unnecessary instability engendered by inflation must be quieted.

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are key to long-run economic growth. In pursuing our objectives, we must remain acutely aware that the structure of the economy has been changing and growing ever more complex. The relationships between the key variables in the economy are always shifting to a degree, and this evolution presents an ongoing challenge to the business leader, to the econometric modeler, and to those responsible for the conduct of economic policy.

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before. The sensitivity of inflation expectations has been heightened, and, as recent evidence suggests, businesses and households may be becoming more forward-looking with respect to fiscal policies as well.

I believe we are on our way toward reestablishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this Nation. The public, however, clearly remains to be convinced: Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist. But there are glimmers of hope that trust is reemerging. For example, issuers have found receptive markets in recent months for fifty-year bonds. This had not happened in decades. The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued.

It is my firm belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well-positioned to remain at the forefront of the world economy well into the next century.

For use at 9:45 a.m., E.D.T.
Tuesday
July 20, 1993

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 20, 1993

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1993

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress, pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,

Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1993 and 1994

In February, when the Federal Reserve prepared its monetary policy plans for 1993, the broad trends in the economy appeared favorable. After a hesitant beginning, the economic expansion had picked up steam in the latter part of 1992, while inflation seemed still to be headed downward. Most members of the Federal Open Market Committee (FOMC) and nonvoting presidents anticipated that 1993 would be a good year for growth and would also see further progress toward price stability.

As the year has unfolded, however, the economy's performance has fallen short of these expectations. Economic growth has slowed appreciably from the pace late last year; in part, this has reflected a retreat in business and consumer confidence and the effects on our trade balance of weakness in a number of other industrial countries. Like most private forecasters, the Board members and Bank presidents generally have trimmed their projections of growth in real gross domestic product (GDP) for the year as a whole, although they continue to foresee increases in output large enough to extend the reduction in the unemployment rate that began last summer. Events on the price side also have been disappointing. The inflation rate in the first part of this year was higher than in late 1992. There is evidence that some of the pickup in the consumer price index (CPI) may have reflected difficulties in seasonal adjustment, and price data for the past couple of months have been much more favorable. Nonetheless, a broad array of indicators points to a leveling out of the underlying inflation trend.

In this circumstance, and with short-term interest rates unusually low, especially when compared with inflation, the Federal Reserve recognized a need to be alert to the possibility that the balance of risks in the economy could shift soon in a direction dictating some firming of policy; failure to act in a timely manner could lead to a buildup of inflationary pressures, to adverse reactions in financial markets, and ultimately to the disruption of the growth process. To this point, however, the moderate thrust of aggregate demand and considerable slack in the economy, taken together with the more subdued price data of late, do not suggest that a sustained upswing in inflation is at hand. Accordingly, the Federal Reserve has not adjusted its monetary policy instruments.

The pace of economic growth in the final quarter of 1992 was not expected to be sustained, but the slowing in the first quarter of 1993 was surprisingly sharp. With the exception of business fixed investment, the slowdown cut across the major categories of final demand. After stepping up their spending in late 1992, consumers became more pessimistic about their economic prospects and more cautious in their spending decisions; the uncertainty surrounding the efforts to reduce the federal deficit may have been a factor in the weakening of household sentiment. Housing activity, which also had been exceptionally strong late last year, hit a lull—even before the March blizzard on the East Coast—and real defense purchases plunged. Moreover, net exports deteriorated sharply, as exports declined and imports surged; the drop in exports was attributable in part to continued weak growth in some other industrial countries and in part was an adjustment to the big increase in late 1992.

The more recent statistical indicators, taken together, point to a resumption of moderate growth in real GDP in the second quarter. Most notably, on the positive side, the increase in aggregate hours worked for the quarter as a whole—a useful indicator of movements in overall output—was the largest of the current expansion. Sales of motor vehicles also exhibited considerable vigor. But other key indicators were less robust. In particular, after allowing for the effects of the blizzard, consumer spending on items other than motor vehicles was lackluster, and housing activity improved only modestly. In the manufacturing sector, orders generally remained soft, and factory output, after having posted solid gains over the preceding seven months, is estimated to have declined somewhat over May and June.

Broad measures of inflation picked up in early 1993, with monthly increases through April in the upper part of the range of the past couple of years. Although readings on consumer and producer prices were much more favorable in May and June, the cumulative price and wage data for the year to date suggest that underlying inflation has flattened out, after trending down over the preceding two years. Excluding the especially volatile food and energy components, the twelve-month change in the CPI has held in the range of 3¼ to 3½ percent since the summer of 1992.

In financial markets, short-term interest rates have changed little so far in 1993, while intermediate- and long-term interest rates have fallen three-quarters to one percentage point to their lowest levels in over twenty years. The decline in longer-term rates seems

largely to have been a response to the enhanced prospects for credible fiscal restraint, though the slower pace of economic expansion may also have played a role. Falling interest rates have helped stock market indexes set new records. Despite a decline in the dollar versus the yen, the average value of the dollar on a trade-weighted basis relative to G-10 currencies has risen, on balance, since the end of 1992. Although foreign intermediate-term interest rates have been down, on average, about as much as U.S. interest rates, short-term rates abroad have decreased substantially relative to U.S. rates, as foreign monetary authorities have taken steps to bolster weak economies.

Declining U.S. market interest rates contributed to robust growth in narrow measures of money and in reserves over the first half of the year, but broad monetary aggregates were very weak and their velocities continued to show exceptional increases. Credit demands on depositories remained quite subdued relative to spending, considerable depository credit was funded from nonmonetary sources, and savers continued to demonstrate a marked preference for capital market instruments over money stock assets.

In part owing to the drop in bond and stock yields, as well as to the desire to strengthen balance sheets, corporate borrowers have continued to concentrate credit demands on long-term securities markets, using the proceeds in part to repay bank loans; business loans at banks have not grown this year, although there were tentative signs of a pickup over May and June. Total lending and credit growth at banks has risen only slightly from the depressed pace of 1992, and these institutions have therefore not needed to pursue deposits. Thrifts have continued to contract, but at a much slower pace than in recent years.

Banks have eased lending standards for smaller firms for several quarters and recently relaxed standards for medium- and large-sized firms as well. An increased willingness to lend on the part of banks has been associated with considerably more comfortable capital positions. Banks have continued to strengthen their balance sheets by issuing large volumes of equity and subordinated debt, while retaining a substantial amount of earnings. As a result, the portion of the industry that is well-capitalized (taking account of supervisory ratings as well as capital ratios) increased from about one-third at the end of 1991 to more than two-thirds by March 1993.

In turning to equity and other nondeposit funds, banks have reduced the share of depository credit that is financed by monetary liabilities. Depositors, for their part, have continued to shift funds into capital markets, attracted by still-high returns in these markets relative to earnings on deposits. Inflows into bond and equity mutual funds have run at record levels this year, and banks have facilitated investing in mutual fund products by increasingly offering them in their lobbies. As a consequence of these various forces, M2 increased at only a 3/4 percent annual rate from its fourth-quarter 1992 average through June, while M3 fell slightly. The sum of M2 and estimated household holdings of long-term mutual funds grew at about a 4 3/4 percent rate from the fourth quarter through June, little changed from the pace of recent years.

Debt growth has edged up this year, despite a deceleration in nominal spending, perhaps buoyed by improvements in financial positions achieved over the past few years by both borrowers and lenders. Investment outlays are estimated to have exceeded the internal funds of corporations for the first time in two years, while household borrowing has picked up relative to spending. In addition, Treasury financing needs have remained heavy. Nevertheless, nonfinancial debt growth has been running at only a 5 percent rate this year.

Monetary Objectives for 1993 and 1994

In reviewing the annual ranges for the monetary aggregates in 1993, the FOMC noted that the relationship of broadly defined money to income has continued to depart from historical patterns. The annual velocities of these aggregates last fell in 1986, and their prolonged upward movements since then strongly suggest breaks from previous long-run trends of flat velocity for M2 and slowly decreasing velocity for M3. The rise in the velocity measures has been particularly surprising in the last four years, a period of declining interest rates, normally associated with a reduction in velocity.

In February, anticipating that further balance sheet restructuring and portfolio shifts from deposits to mutual funds would result in further increases in velocity, the FOMC lowered the 1993 growth ranges for M2 and M3 by one-half percentage point from the provisional ranges set in July 1992. In fact, velocities of the broad monetary aggregates have been especially strong; in the first quarter of 1993, the velocities of M2 and M3 posted substantial increases of 6 1/4 percent and 8 percent, respectively, and appear to have recorded additional, but smaller, gains in the second quarter. As a consequence, at its meeting this month, the Committee reduced the 1993 range for M2

Ranges for Growth of Monetary and Credit Aggregates

	1992	1993 (As of February)	1993 (As of July)	1994
Percentage change, fourth quarter to fourth quarter				
M2	2½ to 6½	2 to 6	1 to 5	1 to 5
M3	1 to 5	½ to 4½	0 to 4	0 to 4
Debt	4½ to 8½	4½ to 8½	4 to 8	4 to 8

by an additional percentage point and the range for M3 by another one-half percentage point, leaving them at 1 to 5 percent for M2 and 0 to 4 percent for M3.

The reductions of these growth ranges represented further technical adjustments in response to actual and anticipated increases in velocity and not a shift in monetary policy, which remains focused on fostering sustainable economic expansion while making continued progress toward price stability. With further substantial increases in velocities, continued sluggish expansion of M2 and M3, which are now at the lower ends of their revised ranges, would be consistent with an acceptable track for the economy. Also at the July meeting, the annual monitoring range for the domestic nonfinancial debt aggregate was reduced by one-half percentage point to 4 to 8 percent; growth in this aggregate is likely to continue to be roughly in line with that of nominal GDP.

While the future behavior of the velocities of broad money aggregates was recognized to be difficult to predict with precision at a time of ongoing structural changes in the financial sector, it appears likely that the forces contributing to the unusual strength in velocities will continue for some time, and the FOMC carried forward the revised 1993 ranges for the monetary and debt aggregates to 1994 as well. With considerable uncertainty persisting about the relationship of the monetary aggregates to spending, the behavior of the aggregates relative to their annual ranges will likely be of limited use in guiding policy over the next eighteen months, and the Federal Reserve will continue to utilize a broad range of financial and economic indicators in assessing its policy stance.

Economic Projections for 1993 and 1994

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, generally anticipate that economic activity will strengthen in the second half of 1993 and continue to expand moderately in 1994. The growth of output is likely to be accompanied by further gains in productivity, but increases in employment are projected to be large enough to keep the unemployment rate moving down. Inflation is not expected to change materially over this period.

The forecasts of the Board members and Reserve Bank presidents for economic growth in 1993 are somewhat weaker than in February, mainly because of the shortfall in real growth in the first quarter. Most expect output gains over the balance of the year to be large enough to result in a four-quarter change in real gross domestic product in the range of 2¼ to 2¾ percent; for 1994, the central tendency of the forecasts spans a range of 2½ to 3¼ percent. The civilian unemployment rate, which averaged 7 percent in the second quarter of 1993, is projected to fall to the area of 6¾ percent by the fourth quarter of this year and to drop slightly further over the course of 1994.

Recent developments in the financial sphere should be conducive to the sustained increases in spending projected for the quarters ahead. The financial positions of many households and businesses have continued to improve, and banks are showing signs of greater willingness to make loans. Short-term interest rates are relatively low, and the appreciable declines in long-term interest rates over the past several months should further the process of balance sheet adjustment and are anticipated to provide considerable impetus to business investment and residential construction. It is likely that business investment also will continue to be bolstered by the ongoing push to improve products and boost efficiency through the use of state-of-the-art equipment. Moreover, with at least a moderate pickup in average growth in foreign

Economic Projections for 1993 and 1994

	FOMC Members and Other FRB Presidents	
	Range	Central Tendency
1993		
Percentage change, fourth quarter to fourth quarter		
Nominal GDP	4¾ to 6¼	5 to 5¾
Real GDP	2 to 3½	2¼ to 2¾
Consumer price index	3 to 3½	3 to 3¼
Average level in the fourth quarter, percent		
Civilian unemployment rate	6½ to 7	6¾
1994		
Percentage change, fourth quarter to fourth quarter		
Nominal GDP	4½ to 6¾	5 to 6½
Real GDP	2 to 3¼	2½ to 3¼
Consumer price index	2 to 4¼	3 to 3½
Average level in the fourth quarter, percent		
Civilian unemployment rate	6¼ to 7	6½ to 6¾

industrial countries, the external sector should be exerting a less negative influence on economic activity in the United States.

Despite the improvement in financial conditions, there are reasons to be cautious about the near-term outlook. Efforts this year to bring the federal budget deficit under control already have helped to ease pressures on long-term interest rates, and a successful agreement to reduce deficits significantly will produce substantial benefits over the longer run. But such actions also are expected to exert some restraint on aggregate demand this year and next. Government outlays for defense will continue to contract, extending the dislocations and disruptions that have been evident for some time in industries and regions that depend heavily on military spending. Prospects for higher taxes may already be influencing the behavior of some households and businesses, and the constraint is likely to intensify in 1994. In addition, uncertainties about prospective federal policies reportedly are weighing on businesses and consumers; although the outcome of the Congressional budget deliberations will be known shortly, uncertainties about health care reform are not anticipated to be resolved fully for some time.

Most Board members and Bank presidents expect the rise in the consumer price index over the four quarters of 1993 to be in the range of 3 to 3¼ percent, about the same as the increase over the four quarters of 1992. At this stage, the food and energy sectors are not expected to have much effect, on balance, on the broad price measures in 1993, but the flooding in the Midwest raises the risk of higher food prices in the quarters ahead. For 1994, the central tendency forecast is for CPI inflation in the range of 3 to 3½ percent, not much different than in 1992 and 1993.

The fundamentals remain consistent with additional disinflation: businesses continue to focus on controlling costs, and slack in labor and product markets is anticipated to decrease only gradually in the period ahead. However, the disappointing price performance in the first half of the year suggests that further progress will not come easily—in part perhaps

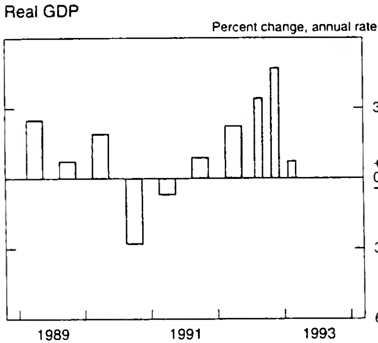
because inflation expectations remain high. Lowering inflation and inflation expectations over time, and achieving sustained reductions in long-term interest rates, will depend importantly on a monetary policy that remains committed to fostering further progress toward price stability. The performance of prices and the economy also will depend on government policies in other areas. Namely, a sound fiscal policy, a judicious approach to foreign trade issues, and regulatory policies that preserve flexibility and minimize the costs they impose are crucial to reestablishing the disinflation trend of the past couple of years and allowing the economy to perform at its full potential.

The Administration has not yet released the mid-year update to its economic and budgetary projections. However, statements by Administration officials suggest that the revised forecasts for real growth and inflation in 1993 and 1994 are not likely to differ significantly from those of the Federal Reserve.

Section 2: The Performance of the Economy in 1993

Economic activity has continued to advance in fits and starts. After posting robust gains in the second half of 1992, real gross domestic product (GDP) rose at an annual rate of less than 1 percent in the first quarter of 1993. The slowing in activity was evident in a broad range of production and spending indicators. The more recent data suggest that the economy expanded at a firmer pace in the second quarter, although growth probably was not as rapid as in the second half of last year.

Real GDP



To some extent, the slackening in economic activity in the first quarter of 1993 can be interpreted as a pay back after two quarters of strong growth. In particular, much of the slowing was in consumer spending, where large gains in the second half of 1992 had outpaced income growth by a substantial margin. In addition, there was a sharp contraction in defense spending; although real defense purchases clearly will remain on a downtrend for some time, the first-quarter plunge followed a spurt in the second half of 1992 and is not likely to be repeated in coming quarters. In the external sector, exports declined in the first quarter after a big increase late last year, while imports rose markedly. Activity was also depressed, especially in the housing sector, by unusually bad weather last winter.

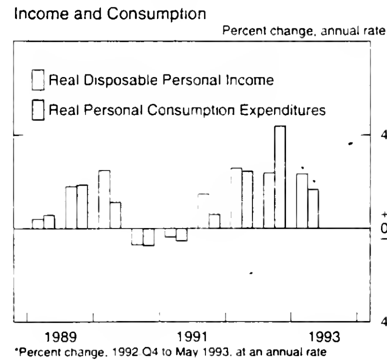
Moderate growth in real GDP appears to have resumed in the second quarter. Nonetheless, experience thus far in 1993 has underscored that the impediments to a more rapid pace of economic expansion over the near term remain sizable. Besides defense cutbacks, the process of balance sheet adjustment goes on, as do the restructuring efforts under way at many large firms. Moreover, the continued disappointing economic performance of some major foreign industrial countries is taking a toll on U.S exports. Finally, uncertainties about prospective federal policies on a variety of fronts, although difficult to measure, are reportedly making some businesses and consumers reluctant to make major hiring and spending commitments.

News on the price side was also worrisome in the first half of the year. Month-to-month movements in prices were on the high side through April, but they moderated in May and June. The more favorable recent data helped to ease concerns that a significant pickup in inflation was under way. Nonetheless, the disinflation process seemingly has stalled, with underlying inflation, as measured by the twelve-month change in the consumer price index (CPI) excluding food and energy, holding in a narrow band between 3¼ and 3½ percent since last summer.

The Household Sector

Growth of consumer spending on goods and services continued in a stop-and-go pattern in early 1993: It hit a lull in the first quarter after surging in the second half of 1992. Averaging through the quarterly data, consumption grew at about a 3 percent annual rate pace over those three quarters, and available data point to a moderate increase in the second quarter. Housing activity appears to have revived in recent months, after sagging earlier in the year.

Income and Consumption



*Percent change, 1992 Q4 to May 1993, at an annual rate

Consumer spending increased only about 1 percent at an annual rate in real terms in the first quarter. Outlays for goods were especially weak, down at about a 2 percent annual rate; although a part of the drop was probably attributable to the severe blizzard on the East Coast in March, signs of some retreat in spending had already appeared in January and February. Meanwhile, spending on services remained on the moderate uptrend that had been evident for the past few years.

Spending rose appreciably in April, spurred by a post-blizzard bounce-back in outlays for motor vehicles and other goods. Demand for motor vehicles remained strong through June, resulting in an average sales pace for the quarter of almost 14½ million units (annual rate)—the highest since early 1990. Sales were boosted by the replacement needs of households that put off buying vehicles during the 1990–91 recession and the early recovery period. In addition, price increases—at least for models with domestic nameplates, which have accounted for almost all of the rise in sales this year—have been relatively small, and financing terms favorable. Meanwhile, real spending on goods other than motor vehicles appears to have posted a moderate gain for the quarter as a whole, and outlays for services rose slowly through May.

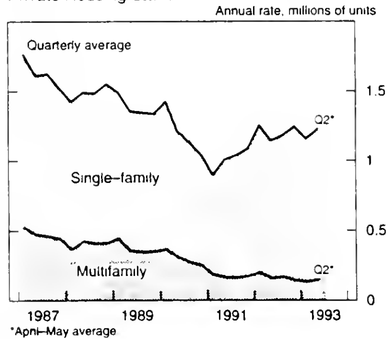
The downshift in overall spending growth this year does not appear to be attributable to any worsening of the current trends in household incomes and financial positions, but it has coincided with a deterioration in consumer confidence. In contrast to the ebullience evident last fall, surveys conducted by the University of Michigan and the Conference Board this year have found respondents more pessimistic about their job and income prospects. Spending may also have been crimped by smaller-than-usual tax refunds—or larger tax bills—this year. Although the change in withholding schedules in March 1992 raised workers' take-home pay, and thus provided the wherewithal to fund additional purchases last year, many households may well have found themselves less liquid than usual in early 1993. More fundamentally, the slowing in spending appears to reflect a return to trend after a surge that outstripped the rise in real disposable income in the second half of last year. Indeed, after having risen somewhat over the preceding couple of years, the personal saving rate dropped from 5¼ percent in the second quarter of 1992 to 4½ percent in the fourth quarter, in the lower part of the range of recent years. The saving rate retraced some of that decline in the first quarter, but it appears to have fallen back in the spring.

Real disposable income has remained on the moderate uptrend that has been evident for the past several quarters: In May, it stood about 2¼ percent above the level of a year earlier. Growth in wages and salaries has stayed relatively sluggish despite the firmer pace of employment growth this year. Meanwhile, transfer payments have continued to expand, although recent increases have been diminished by a drop in unemployment insurance benefits as the number of unemployed has declined. Interest income, which fell appreciably over 1992, has only edged down thus far this year.

Household financial positions have continued to show signs of improvement. The value of household assets has been buoyed by the rising stock market, while debt growth has remained moderate. Moreover, reductions in interest rates have continued to lower debt-servicing burdens; when measured in relation to disposable income, the repayment burden has fallen back to the levels of the mid-1980s. The incidence of financial stress among households also appears to have eased further. Delinquency rates on consumer loans generally dropped again in the first quarter and are down significantly from their recent peaks, and delinquencies on home mortgages are at the low end of the range of the past decade.

Housing activity turned surprisingly soft in the first quarter, after a burst at the end of 1992. However, the most recent monthly indicators suggest that the sector remains on a path of gradual expansion. In the single-family area, both starts and sales of new homes fell back at the beginning of the year and remained below trend through March. Single-family starts rebounded in April and edged up further in May, lifting the

Private Housing Starts



average level for the two months about 5 percent above the first-quarter pace; new home sales gyrated in the spring but also were higher, on average, than in the first quarter.

Undoubtedly, some of the recent improvement reflects a reversal of transitory factors that damped homebuilding in the first quarter. The East Coast blizzard delayed both builders and their customers in March; in addition, the weather for the nation as a whole was slightly worse than usual in January and February. Lumber prices ran up sharply between October and March: As measured by the producer price index (PPI), prices rose about one-third over that period, and spot market quotes for some lumber products more than doubled. The jump in lumber costs, which has since been reversed, seems not to have left much of a mark on the prices recorded in sales transactions; indeed, the inability of builders to pass along the cost increases may have accounted for some of the disruption in construction activity.

In any event, low mortgage rates clearly are helping to stimulate housing demand. Interest rates on fixed-rate home mortgages, like most other long-term interest rates, fell to near their twenty-year lows last winter and have since declined further; initial rates on adjustable-rate mortgages have been the lowest since these loans first became widely available at the beginning of the 1980s. Given the trends in house prices, these interest rates have pushed the cost of home purchase—as measured by the share of household income needed to make the mortgage payments on an average home—to the lowest levels since the mid-1970s.

Nonetheless, the trends in house prices this year—small rises in some markets, declines in others—have not been a uniform positive for demand, mainly because they have muted the investment motive for owning a home. Moreover, although most respondents to the Michigan survey in recent months reported that it was a good time to buy a house, only about one-third of those who already owned homes thought it was a good time to sell. In fact, industry reports suggest that first-time homebuyers have accounted for an unusually large share of all home purchases in the past two years, and that sales and prices in many localities have been strongest at the lower end of the market.

Construction of multifamily housing this year has been at its lowest level since the 1950s. These structures—most of which are intended for rental use—now account for less than 5 percent of total residential investment expenditures, compared with a figure of about 15 percent in the mid-1980s. Despite the reduced production in the past several years, vacancy rates and rents have not yet shown clear signs of tightening for the nation overall. By contrast, improvements to all existing housing units have trended up over the past year and now account for nearly one-fourth of total residential construction expenditures.

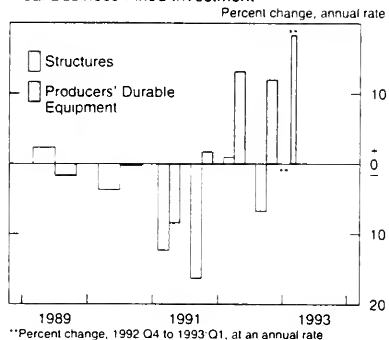
The Business Sector

Developments in the business sector generally were favorable in the first half of 1993. Business fixed investment continued to grow briskly, boosted by ample profits and cash flow, the relatively low cost of capital, and ongoing efforts to improve productivity. Meanwhile, business balance sheets strengthened further as growth of business debt remained relatively slow and many firms continued to take advantage of lower bond yields and high stock prices to enhance liquidity by funding out short-term liabilities.

Real business fixed investment increased at a 13 percent annual rate in the first quarter of 1993. Real outlays for equipment posted another healthy gain, and investment in structures, which had been on a protracted decline for some time, was about unchanged for a second quarter. The indicators in hand suggest that real business fixed investment remained strong in the second quarter.

Equipment spending has continued to be a mainstay of economic growth. It rose at an annual rate of about 18 percent in real terms in the first quarter, after a 12½ percent rise over the course of 1992. Real

Real Business Fixed Investment



**Percent change, 1992 Q4 to 1993 Q1, at an annual rate

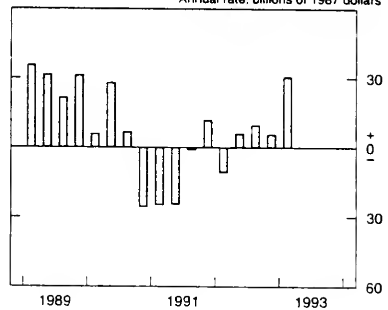
outlays for computers and related devices have continued to soar; since early 1991, they have roughly doubled, boosted by product innovations, extensive price-cutting by computer manufacturers, and the ongoing efforts of businesses to achieve efficiencies through the utilization of new information-processing technologies. However, demand for other, more traditional types of equipment also began to grow around the middle of 1992 and continued to expand in early 1993. Domestic purchases of aircraft spurted in the first quarter; but, given the financial problems besetting the airlines, this increase will likely be reversed in coming quarters.

Investment in nonresidential structures appears to be stabilizing after several years of steep declines. Construction outlays were essentially flat in real terms over the fourth and first quarters, and the advance indicators suggest that the bottom has been reached or is close at hand. Trends within the construction sector have been divergent. In the office sector, the excess of unoccupied space remains huge, and spending continues to contract. However, spending for commercial structures other than office buildings, which also had fallen sharply over the past several years, has apparently turned the corner, because of both the stronger pace of retail sales over the past year and the ongoing shift of retailing activity to large suburban stores. Outlays for industrial construction have not exhibited the normal cyclical rebound—mainly because utilization of existing capacity has tightened only gradually—but they seem, at least, to be leveling out. Meanwhile, activity in the public utilities sector has continued to trend up, mainly because of capacity expansion at electric utilities but also because of the installation of pollution abatement technology, which the Clean Air Act requires be in place by 1995. In contrast, drilling activity remains depressed.

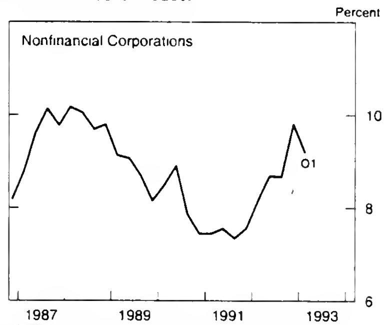
Nonfarm business inventories, which had shown only small changes, on net, since the middle of 1991, rose considerably last winter and spring. Although the buildup early in the year was likely motivated in part by the need to replenish stocks drawn down by surprisingly strong sales in late 1992, some of the recent increase may be attributable to softer-than-expected sales. Notably, the inventory–sales ratio for non-auto retail stores remained in May around the high end of the range of recent years. By contrast, inventories at factories and at wholesale trade establishments generally seem to be reasonably well aligned with sales.

After advancing markedly over the course of 1992, economic profits of U.S. corporations were little changed overall in the first quarter of 1993. The pre-tax profits earned by nonfinancial corporations on their domestic operations weakened after a fourth-quarter surge, but they still stood nearly 35 percent above the cyclical low reached in 1991; the upswing in these profits over the past two years has reflected primarily a combination of restraint in labor costs and reductions in net interest expenses. Domestic profits of financial corporations have been buffeted in recent quarters by the losses that insurance companies sustained from major natural disasters; without such losses, domestic financial profits in the first quarter would have surpassed the high reached in the first quarter of 1992.

Changes in Real Nonfarm Business Inventories



Before–tax Profit Share of Gross Domestic Product*



*Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector

The farm economy has been beset by numerous weather disruptions so far this year. In the first quarter, severe weather in some regions retarded livestock production and damaged fruit and vegetable crops. In many regions, spring planting was hampered by wet weather, and, in parts of the Midwest, continued heavy rains around mid-year caused major flooding. Because of the planting delays and the floods, uncertainties about acreage and yields are considerably greater than usual for this time of year, and farmers in the flooded regions obviously have suffered financial losses.

Despite the weather-related supply disruptions, farm income and farm financial conditions for the nation as a whole seem to have held up reasonably well in the first half of 1993. On average, farm prices in the first half were slightly above those of a year earlier, with declines for farm crops being offset by higher prices for livestock. Farm subsidies, which have been running well above their 1992 pace, have been lifting farm income and cash flow, and farm investment in new machinery has picked up. The recent jump in crop prices—a consequence of the flooding—will boost the incomes of the many farm producers whose crops are still in good condition.

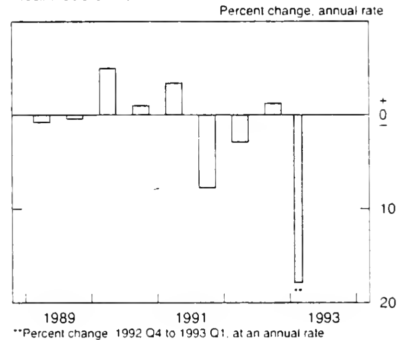
The Government Sector

Governments at all levels continue to struggle with budgetary difficulties. At the federal level, the unified budget deficit over the first eight months of FY1993—the period from October to May—totaled $212 billion, somewhat less than during the comparable period of FY1992. However, excluding deposit insurance and adjusting for the inflow of contributions to the Defense Cooperation Account in FY1992, the eight-month deficit was about $230 billion in both fiscal years. In the main, the underlying deficit has failed to drop because the restraint in discretionary spending that was legislated in 1990 and the deficit-closing effects of stronger economic activity have been offset by continued large increases in spending for entitlement programs.

In total, federal outlays in the first eight months of FY1993 were only about 2 percent higher than during the same eight months of FY1992. Outlay growth was damped significantly by a sharp swing in net outlays for deposit insurance that was attributable largely to the improved health of depository institutions. In fact, so far this year, receipts from insurance premiums and proceeds from sales of assets taken over by the government have exceeded by $18½ billion the gross outlays to resolve troubled institutions. Defense spending was also quite weak in the first eight months of FY1993. Outlays for Medicare and Medicaid continued to rise rapidly; however, the increase so far this year—about 10 percent—was only half as large as the one in the preceding year. The deceleration in health care spending appears to stem, in part, from federal regulations issued in 1992 that limit the states' ability to shift Medicaid costs to the federal government.

Federal purchases of goods and services—the part of federal spending included directly in gross domestic product—declined at an annual rate of 18 percent in real terms in the first quarter of 1993. A sharp decrease in defense spending more than accounted for the drop. Real defense purchases have been falling noticeably since early 1991, but the decline has been erratic; at least part of the first-quarter plunge can be interpreted as a correction after a few quarters of surprisingly strong spending. Meanwhile, real nondefense purchases have been almost flat over the past couple of quarters.

Real Federal Purchases

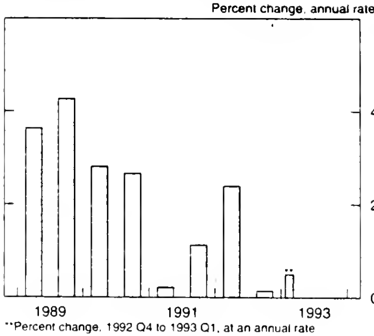


**Percent change 1992 Q4 to 1993 Q1, at an annual rate

Federal receipts in the first eight months of FY1993 were about 5 percent greater than in the same period of a year earlier; the rise was roughly the same as that in nominal GDP. Boosted by the upswing in business profits, corporate taxes rose sharply. However, they account for less than one-tenth of total receipts, and growth in other categories was only moderate in the aggregate.

States and localities continue to face sizable budget deficits. As measured in the National Income and Product Accounts (NIPA), the combined deficit (net of social insurance funds) in the sector's operating

Real State and Local Purchases



**Percent change, 1992 Q4 to 1993 Q1, at an annual rate

and capital accounts has been stuck around $40 billion since late 1990. These outsized deficits have persisted despite ongoing efforts by many governments to adjust spending and taxes. As at the federal level, deficit reduction has been complicated by the upsurge in payments to individuals for health and income support; in the first quarter of 1993, state and local transfer payments for Medicaid and Aid to Families with Dependent Children (in nominal terms) were nearly 20 percent above those of a year earlier.

The deficit-reduction efforts of state and local governments in recent quarters have been concentrated on the spending side. Their purchases of goods and services were nearly flat in real terms in the first quarter of 1993 and have changed little, on net, since early 1992. Outlays for construction, which fell at an annual rate of 7 percent, on average, in the fourth and first quarters, have been especially weak. For all major categories except sewer and water, outlays in recent months have been running significantly below year-earlier levels. State and local employment has continued to expand at the somewhat slower pace that has been evident since 1991, while these governments have continued to hold the line on wages and benefits. The approximately 3½ percent increase in state and local compensation rates over the year ended in March was similar to the rise for workers in private industry; by contrast, in the 1980s, state and local workers received increases that, on average, were more than a percentage point per year greater than those in private industry.

Receipts of state and local governments, restrained by the relatively tepid cyclical upswing in the sector's tax bases, have grown only moderately over the past year. Also, these governments have lately been reluctant to raise taxes, after the sizable hikes they enacted in 1990 and 1991. All told, the sector's own-source general receipts, which comprise income, corporate, and indirect business taxes, rose 5 percent over the four quarters ended in the first quarter of 1993, about the same that nominal GDP increased.

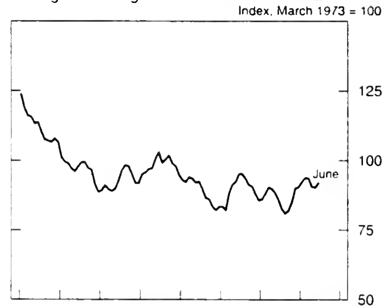
The External Sector

Since December 1992, the trade-weighted foreign exchange value of the dollar has risen about 5 percent, on balance, in terms of the currencies of the other Group of Ten (G-10) countries. This net increase has reflected much larger movements in the dollar's value against individual currencies: In particular, a sharp decline against the Japanese yen was more than offset by substantial increases against major European currencies.

Relative to the monthly average for December 1992, the dollar has declined nearly 15 percent against the yen to record lows, prompting heavy Japanese official purchases of dollars and moderate dollar purchases by U.S. authorities. The strengthening of the yen has occurred despite the weak performance of the Japanese economy and market expectations that Japanese short-term interest rates will remain near historically low levels over the next year; it seems to be based largely on the perception that Japan's external surplus, which has grown rapidly over this period, is not sustainable.

Against the German mark, the dollar has risen almost 10 percent since December, reflecting a sub-

Foreign Exchange Value of the U.S. Dollar *



*Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are based on 1972-76 global trade of each of the 10 countries.

stantial easing of German interest rates and the expectation of further declines in light of the sharp contraction in German economic activity. The dollar has also appreciated against other European currencies, and it has remained little changed against the Canadian dollar.

Economic activity in the major foreign industrial countries generally has been sluggish so far this year. The recovery in Canada now seems to be reasonably well established, and real GDP in the United Kingdom has been growing slowly. However, continental Europe remained in recession in the first quarter, with a sizable reduction in real GDP in western Germany; recent indicators point to continued weakness in the second quarter. After falling for much of 1992, Japanese real GDP rose in the first quarter, in large part reflecting the effects of earlier fiscal measures; however, indicators for the second quarter are mixed, and the appreciation of the yen will likely result over time in a drag on net exports.

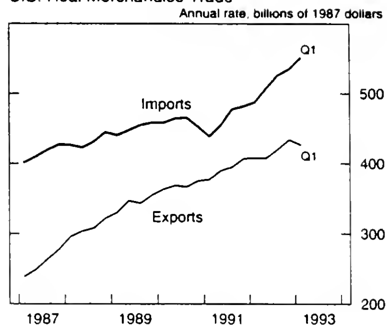
Unemployment rates have continued to rise (into the double-digit range in many instances) in the countries still in recession; even in the countries showing signs of recovery, unemployment has remained high. Partly as a consequence, wage pressures have ebbed, and underlying inflation has continued to decelerate, on average. A notable exception is western Germany, where the CPI rose more than 4 percent over the twelve months ended in June, partly because of an increase in the value-added tax early this year and large increases in the prices of housing services.

In contrast to the overall weakness of activity in foreign industrial countries, real growth so far this year in major developing countries, especially in Asia, appears to have remained at around the strong pace of 1992.

After expanding rapidly at the end of 1992, real merchandise exports declined during the first quarter of 1993, but they bounced back to their fourth-quarter 1992 high in April and May. Shipments to developing countries, which had risen sharply over 1992, dropped back during the January-to-May period. In the aggregate, exports to industrial countries rose somewhat in the first five months of 1993, but Canada and the United Kingdom accounted for most of the increase.

Real merchandise imports, extending the rapid pace of growth recorded over the four quarters of 1992, rose sharply over the first five months of 1993. Trade in computers continued to soar and was responsible for about one-third of the increase in merchandise imports. More broadly, imports were boosted by the

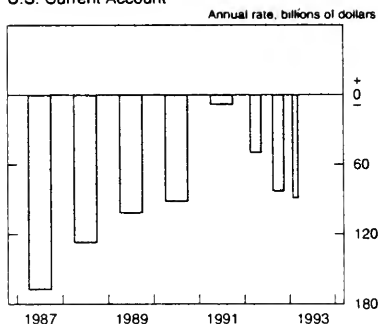
U.S. Real Merchandise Trade

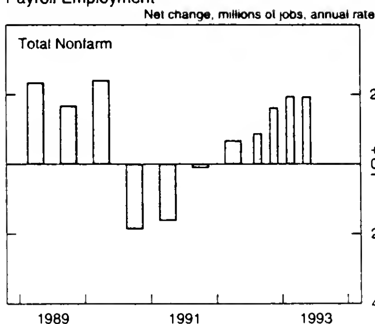


rapid growth of U.S. domestic final demand in the second half of 1992 and inventory restocking this year. In addition, the prices of non-oil imports, reflecting the lagged effects of the appreciation of the dollar during the last quarter of 1992, fell somewhat in the first quarter; much of that decline appears to have been reversed in the second quarter. The price of oil imports fluctuated in a relatively narrow range over the first half of 1993. Mild weather and strong OPEC production pushed oil prices down early in the year, but prices subsequently retraced the decline on signs that OPEC would effectively curb production. Recently, oil prices have dropped on Kuwait's decision not to participate in OPEC's quota allocations for the third quarter and speculation that Iraq may be allowed to resume exporting sooner than had been expected.

The merchandise trade deficit widened to $116 billion (at an annual rate) in the first quarter of 1993, nearly $10 billion greater than in the second half of 1992; it increased somewhat further in April and May, on average. With moderate increases in net direct investment income receipts and a slight further widening of the surplus on net service transactions, the current account deficit rose somewhat less than the trade deficit, to $89 billion (annual rate) in the first quarter, compared with $83 billion in the second half of 1992.

Net capital inflows recorded in the first quarter of 1993 were largely attributable to substantial increases in foreign official assets held in the United States, particularly in those of some newly industrializing Asian economies and of certain Latin American countries. Net private capital inflows were relatively small.





Private foreigners added significantly to their holdings of U.S. securities, particularly Treasury bonds. However, U.S. net purchases of foreign bonds reached record levels, and net purchases of foreign stocks, although down from peak levels reached in the last half of 1992, remained heavy. New bond issues by foreigners in the United States also were very strong.

Capital inflows associated with foreign direct investment in the United States recovered substantially in the first quarter but remained far below the peaks reached in 1989. Foreign direct investment in the United States apparently has been deterred by unfavorable returns realized on earlier investments and by financial market conditions less favorable to acquisitions. In contrast, capital outflows associated with U.S. direct investment abroad remained strong.

Labor Market Developments

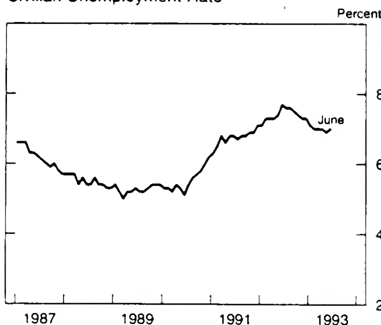
The labor market showed signs of improvement in the first half of 1993. According to the payroll survey, employment increased about 1 million; this number compares with a rise about 600,000 over the second half of last year and brings the total increase since the cyclical low in 1991 to about 2 million.

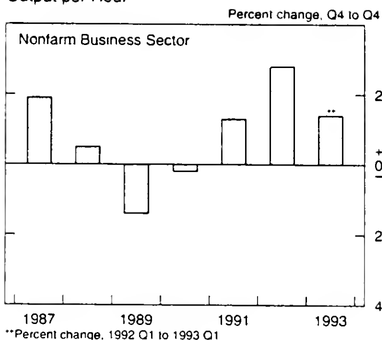
Nonetheless, job gains have continued to fall far short of the norms set by earlier business cycle expansions. For example, only in May did payroll employment return to its pre-recession peak, two years after the cyclical trough; by contrast, recessionary job losses typically have been reversed within the first year of the expansion. Job growth has continued to be restrained by the temperate pace of economic activity and employers' ongoing efforts to improve productivity. In addition, firms are confronting cost pressures associated with sizable increases in health insurance premiums and in other fringe benefits; uncertainties about the future course of government policies may also be contributing to the reluctance of some firms to expand their permanent full-time work forces.

Moreover, firms are relying increasingly on temporary workers, in part because doing so affords them greater flexibility in responding to fluctuations in demand for their products. Indeed, employment at personnel supply firms, which consist largely of temporary-help agencies, rose more than 150,000 between December and June. Over the past two years, the increase has been about 500,000; thus, although these firms currently account for less than 2 percent of total payroll employment, they are responsible for one-quarter of the increase in total employment over this period.

Job gains in the first half of 1993 also reflected a continuation of the steady uptrend in employment in health services. In addition, gains occurred at trade establishments, construction payrolls improved with the recent stronger housing activity, and there were scattered increases in services other than health and personnel supply.

Meanwhile, manufacturing employment declined further, on balance, over the first six months of the year. Although factory output increased steadily through April, firms relied mainly on a combination of productivity improvements and longer workweeks to meet their output objectives; in May and June, output decreased somewhat. Job losses in the first half were concentrated in the durable goods sector, with particular weakness at producers of aircraft and motor vehicles. Since its last peak in January 1989, manu-





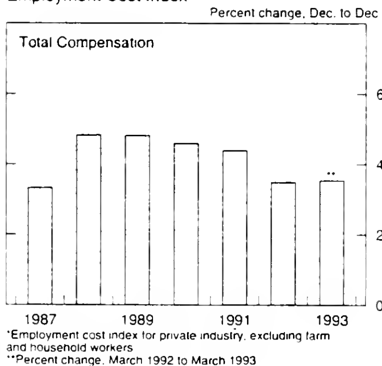
facturing employment has fallen about 1¾ million; layoffs in defense-related industries (those industries that depend on defense expenditures for at least 50 percent of their output) have accounted for about one-fifth of the decrease in total factory payrolls.

Employment as measured by the monthly survey of households rose about 900,000 over the first six months of the year—essentially the same as in the payroll series. The number of unemployed fell appreciably at the beginning of the year, and the civilian unemployment rate dropped from 7.3 percent in December to 7.0 percent in February; it has shown little change since that time.

The civilian labor force expanded only modestly over the first six months of 1993—less than 1 percent at an annual rate. Labor force growth continued to be damped by the relatively small increase in the working-age population. In addition, perceptions of meager employment opportunities evidently continued to deter many potential job seekers. The labor force participation rate, which measures the percentage of the working age population that is either employed or looking for work, spurted in late spring, however, this spurt followed a sharp decline earlier in the year, and the level at mid-year was about the same as that in late 1992.

Output-per-hour in the nonfarm business sector declined at an annual rate of 1½ percent in the first quarter, echoing the sharp deceleration in output. Nonetheless, the first-quarter drop followed a string of sizable increases; all told, the rise in productivity over the year ending in the first quarter of 1993 amounted to 1½ percent—smaller than the gains recorded earlier in the economic expansion, but still noticeably larger than the norms for the past decade. Productivity growth in the manufacturing sector, where downsizing and restructuring efforts have been under way for some time, has continued to be especially impressive, totaling more than 5 percent over the past year.

Labor compensation has tilted up of late. The employment cost index for private industry—a measure that includes wages and benefits—rose at an annual rate of 4¼ percent over the first three months of the year. Even so, the data are volatile, and the total increase since March 1992 amounted to only 3½ percent; by contrast, this index had risen 4¼ percent over the preceding twelve months, and, as recently as early



1990, the twelve-month change had exceeded 5 percent. The increase in wages over the past year was less than 3 percent, whereas the cost of fringe benefits, pushed up by the steep rise in the cost of medical insurance and by higher payments for workers' compensation, rose more rapidly. Primarily because of the drop in productivity, unit labor costs deteriorated markedly in the first quarter, but they still were up less than 2 percent over the past year.

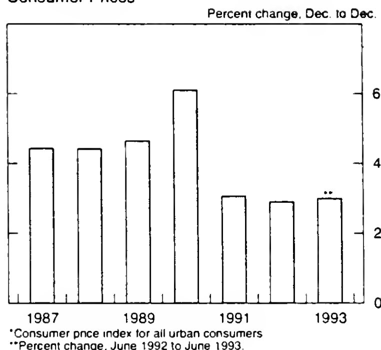
Price Developments

Inflation exhibited considerable month-to-month volatility in the first half of the year. Broad measures of inflation picked up somewhat in early 1993, with monthly readings through April in the upper part of the range of the past couple of years. However, price changes at the consumer and the producer levels were small in May and June. Cutting through the monthly data, the disinflation process evident in 1991 and 1992 seems to have stalled, with underlying inflation, as measured by the twelve-month change in the CPI excluding food and energy, holding in the range of 3¼ to 3½ percent that has prevailed since last summer. The total CPI, held down by essentially flat energy prices, has risen 3 percent over the past twelve months.

The CPI for food increased at an annual rate of 2 percent in the first half of 1993, a shade above the rate of increase during 1992. Meat prices jumped sharply during the first few months of the year as production fell short of year-earlier levels. In addition, the prices of fresh vegetables were boosted during the spring by weather-related production setbacks in several regions of the country. By late spring, these supply problems had abated, and the June CPI brought price declines in food categories where the sharpest upward pressures previously had been evident. Since the end of June, however, farm crop prices have moved up in response to the severe flooding in the Midwest. The increases in crop prices have already been reflected in the form of large advances in some commodity price indexes and have raised the possibility that renewed upward pressures on consumer food prices could soon emerge.

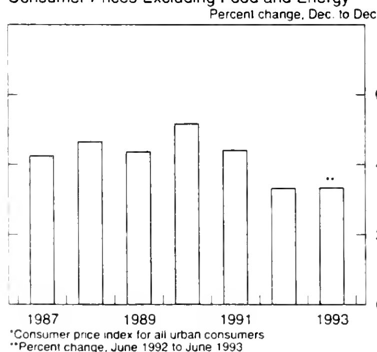
Consumer energy prices changed little, on net, over the first half of the year. With world oil markets remaining relatively quiescent, the price of West-

Consumer Prices*



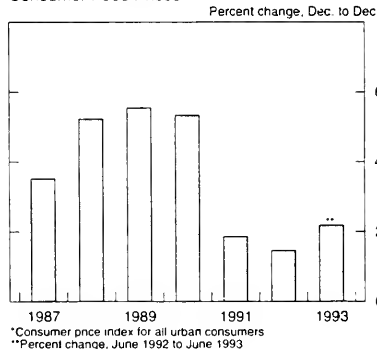
*Consumer price index for all urban consumers
**Percent change, June 1992 to June 1993.

Consumer Prices Excluding Food and Energy*



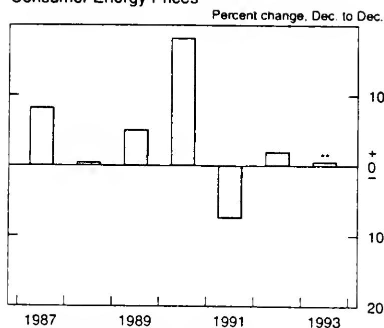
*Consumer price index for all urban consumers
**Percent change, June 1992 to June 1993

Consumer Food Prices*



*Consumer price index for all urban consumers
**Percent change, June 1992 to June 1993

Consumer Energy Prices*



*Consumer price index for all urban consumers
**Percent change, June 1992 to June 1993.

Texas intermediate generally fluctuated between $18 and $20 per barrel but has weakened recently. Retail prices for refined petroleum products changed fairly little on the whole through April and dropped, on balance, in May and June. Residential natural gas prices rose considerably over the first half, in part because of inventory adjustments associated with last winter's colder-than-usual weather; although recent declines in wellhead prices suggest that some of the increase at the retail level may be retraced in coming months, over the longer haul, natural gas prices are being supported by an ongoing shift toward the use of cleaner-burning fuels.

All told, the CPI excluding food and energy increased at an annual rate of 3½ percent over the first half of the year, after rising 3 percent over the second half of 1992. The CPI for goods soared in January and February, with large increases reported for several items. Apparel prices jumped early in the year, in part because strong sales in late 1992 limited the need for post-Christmas markdowns. Some retailers may also have seen opportunities to widen profit margins on other merchandise; the recent decrease in prices of home furnishings, for example, suggests that not all of these increases stuck.

Increases in prices of non-energy services were steadier but also somewhat larger than in 1992. Part of the step-up was in shelter costs, which account for about half of non-energy services and had posted some unsustainably small increases last summer. However, the substantial deceleration in medical care prices (for both goods and services) that has been in train over the past few years extended into 1993. In fact, the CPI for medical care rose only about 6 percent over the twelve months ended in June; this increase was among the smallest of the past decade.

To some extent, the higher underlying CPI inflation rates in the first half of 1993 may be a statistical phenomenon that will be reversed in the second half: Indeed, over the past several years, price increases early in the year have tended to exceed those for the year as a whole, even after seasonal adjustment by the BLS. But, even allowing for this phenomenon, inflation seems to have leveled out. The lack of further deceleration is puzzling in light of the considerable slack in labor and product markets. One possible explanation is that the pickup in economic activity late last year may have triggered a round of price increases; if so, some deceleration in prices is likely in the wake of the subdued performance of the economy in the first half. Another may be the apparent failure of inflation expectations, as measured by various surveys of consumers and businessmen, to reflect fully the reduction in actual inflation over the past few years; although the survey measures vary considerably, respondents seem to share a sense that inflation has bottomed out.

Prices received by domestic producers have slowed in recent months, after undergoing a pickup earlier in the year. All told, the twelve-month change in the producer price index for finished goods other than food and energy was less than 2 percent in June, down somewhat from a year earlier. At earlier stages of processing, where price movements tend to track cyclical fluctuations in demand, prices of intermediate materials (excluding food and energy) firmed a little early in the year, but they subsequently moderated; although the pattern was exaggerated by the spike in lumber prices, it was evident for some other materials as well. In commodity markets, prices of precious metals have moved up sharply over the past couple of months, and some scattered increases have been evident elsewhere. More broadly, however, industrial commodity prices were down slightly, on net, over the first half of the year.

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Section 3: Monetary and Financial Developments in 1993

Monetary policy in 1993 has been directed toward the goal of sustaining the economic expansion while preserving and extending the progress made toward price stability in recent years. In the first half of the year, economic activity slowed markedly from the very rapid pace of the fourth quarter, while inflation indicators fluctuated widely. Although inflation readings were a source of concern for the Federal Open Market Committee, the intensification of price pressures did not seem likely to be sustained over an extended period, and reserve conditions were kept unchanged. With short-term rates steady, prices of fixed-income securities were buoyed by prospects for significant fiscal restraint and by a slowing of the economic expansion, although fears of a pickup in inflation at times prompted partial reversals in bond rates. Yield spreads on private securities relative to Treasury rates remained historically narrow, and stock price indexes set new records.

The monetary aggregates have been sluggish this year, as both the share of depository institutions in overall debt finance and the proportion of depository credit funded with monetary liabilities have fallen further. The reduced role for depositories largely reflects weak demands for loans and deposits by the public. Corporate borrowers have continued to issue heavy volumes of stocks and bonds in part to pay down bank debt, while households have withdrawn deposits to invest in bond and equity funds that finance *inter alia* corporate issuers. After two years of no growth, bank loans weakened further early this year, but increased fairly vigorously in May and June, posting a modest net gain for the first six months of the year. The growth of nonfinancial sector debt so far this year has edged up from the subdued pace of 1992, despite a deceleration of nominal spending, as investment spending is estimated to have exceeded the internal funds of corporations, household borrowing has picked up relative to spending, and Treasury financing needs have remained heavy.

The Implementation of Monetary Policy

Early in the year, incoming data suggested that the faster pace of economic activity that had emerged in the third quarter of 1992 had been maintained through year-end. Indicators of industrial production, retail sales, business fixed investment, and residential construction activity all posted solid gains. Financial impediments to the expansion appeared to be diminishing as the balance sheets of households, business firms, and financial institutions continued to improve, although money and credit growth remained weak. Wage and price data suggested a continuing trend toward lower inflation. Intermediate- and long-term interest rates had declined somewhat, in part reflecting a view that the new Administration's fiscal stimulus package was likely to be modest and that material reductions in future deficits were in prospect. The economic outlook remained clouded, however, by uncertainties regarding details of fiscal policy plans, continued restructuring and downsizing of large businesses, and lingering restraints on credit supplies. At its early February meeting, the Federal Open Market Committee decided that its directive to the domestic open market desk should retain a symmetric stance regarding possible reactions over the intermeeting period to incoming indicators; such a directive, which implied no presumption in how quickly changes in operations should be made toward tightness or ease, had been instituted in December, following directives that had been biased toward easing over much of the previous two years.

Economic activity appeared to decelerate in the early months of the year, however, in part because of adverse weather conditions, with softness in retail sales, housing starts, and nonresidential construction. Bank credit was failing to expand significantly, while broad money was declining owing both to temporary factors and a weak underlying trend. Although short-term interest rates were little changed, bond markets rallied further on weaker economic activity and improved prospects for fiscal restraint, which would reduce the government's demand for credit. Long-term rates fell to the lowest levels in almost twenty years in early March, before backing up somewhat on reports of a second month of substantial increases in consumer and producer prices. The drop in interest rates buoyed stock markets to record highs and contributed to a small decline in the weighted-average value of the dollar. The dollar depreciated substantially against the yen, as market attention focused on Japan's growing trade surplus.

Signs of price pressures were a concern for the FOMC, but the fundamentals of continued slack in labor and capital utilization, subdued unit labor costs, and protracted weakness in credit and broad money suggested that a higher trend inflation rate was not setting in. With the economy slowing, reserve pressures were kept unchanged and a symmetric policy directive was retained at the meeting in March.

After pausing in March, producer and consumer prices leaped again in April. Long-term interest rates backed up further in response; the price of gold surged, and the dollar fell more rapidly. With the Japanese authorities buying dollars in foreign exchange markets, the U.S. Treasury and the Federal Reserve also purchased dollars for yen in late April. After extended weakness, the monetary aggregates jumped in early May by more than could be explained by temporary factors.

At its May meeting, the FOMC was confronted with weak output growth and intensified inflation readings. It was difficult to identify reasons for this juxtaposition. Price increases by business firms in early 1993 could have reflected optimism engendered by strong demand conditions in the second half of 1992 or an upward adjustment of inflation expectations. However, considerable slack remained in labor and product markets, and the pace of economic activity had slowed markedly. The Committee concluded that no policy adjustment was needed at its meeting, but the risks of increased inflation and inflation expectations warranted a directive that contemplated a relatively prompt tightening of reserve pressures if signs of intensifying inflation continued to multiply.

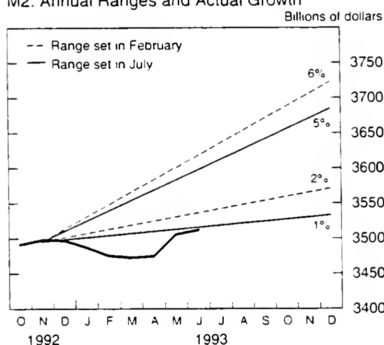
The subsequent readings on inflation for May and June were subdued; moreover, evidence of heightened inflation expectations did not emerge in markets for fixed-income securities. Consequently, the stance of monetary policy was not changed following the May FOMC meeting. The dollar rebounded on foreign exchange markets in June and early July in the wake of the fall of the Japanese government and evidence that economic conditions in Europe had deteriorated further.

On balance, since the beginning of the year, short-term interest rates are little changed, while intermediate- and long-term rates have fallen three-quarters to one percentage point to the lowest levels in over twenty years. In particular, the thirty-year Treasury bond has reached a low of 6.54 percent, while the ten-year Treasury note has touched 5.71 percent, its lowest level since 1971. The fixed-rate thirty-year mortgage interest rate has dropped to 7.16 percent, a record low in the 22-year history of the series. The fall in intermediate-term interest rates in the United States was roughly matched on average abroad, and the trade-weighted value of the dollar in terms of G-10 currencies has increased about 5 percent from its December average, as overseas economies weakened and foreign short-term rates declined substantially.

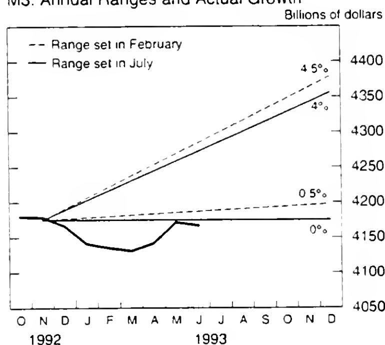
Monetary and Credit Flows

Growth of the broad money measures was quite slow over the first half of 1993, falling below the subdued pace of 1992, and leaving them near the lower arms of the revised growth cones for 1993. This deceleration, however, did not reflect a moderation in overall credit flows or a tightening in financial conditions. Rather, it resulted from a further diversion of credit flows from depository institutions as well as continued financing of depository credit through capital accumulation rather than deposits. Indeed, growth of the debt of all nonfinancial sectors is estimated to have edged up this year—to 5 percent—despite an apparent slowing in nominal GDP. Continued substantial demand for credit by the

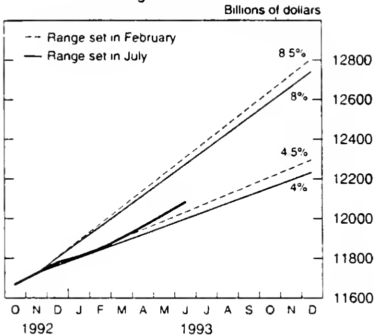
M2: Annual Ranges and Actual Growth



M3: Annual Ranges and Actual Growth



Debt: Annual Ranges and Actual Growth



marketable debt and repay bank loans. Stresses associated with the restructuring of the economy and the earlier buildup of debt linger. However, downgradings of corporate debt by rating agencies have dropped well below the peak levels of a few years ago, and a growing number of firms have received upgradings, as corporate cash flows have strengthened substantially relative to interest expenses.

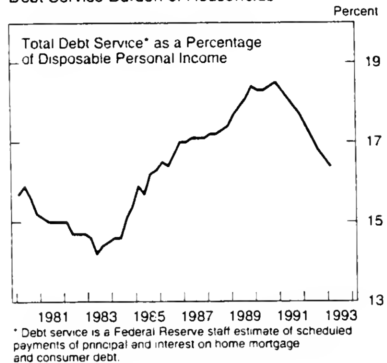
Debt service burdens of households also have continued to decline relative to disposable income, as households have repaid high interest debt or taken advantage of lower rates to refinance. Indeed, the decline in long-term interest rates during the year has brought a new surge of refinancings of mortgages. With balance sheets improved, households have become somewhat more willing to borrow, and consumer credit has begun growing moderately after two years of weakness. Some of that growth, though, may reflect heavy promotion of credit cards carrying special incentives for use in transactions, such as "frequent-flier miles" or merchandise discounts. Net mortgage debt is estimated to have grown only a bit more than the modest rate of 1992.

Gross issuance of state and local government debt has been particularly robust this year. However, refunding volume has accounted for nearly 70 percent of the offerings, compared with about 45 percent in 1992, a record year for refundings. Net debt of state and local governments has grown only moderately again in 1993. The budgetary situations of some state

federal government as well as more comfortable financial positions and consequent signs of a greater willingness to borrow and lend by private sectors likely supported debt expansion. Nevertheless, overall debt growth remains in the lower portion of its revised 4 to 8 percent annual range for 1993. Nonfederal debt growth has expanded at a still modest 3¼ percent pace, after two years of even weaker growth.

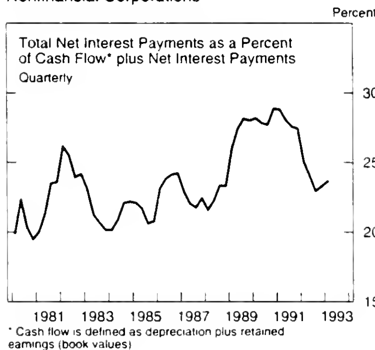
Taking advantage of low long-term interest rates and the strong stock market, businesses have issued an exceptionally large volume of bonds and equity; the proceeds have been used mainly to refund other

Debt Service Burden of Households



* Debt service is a Federal Reserve staff estimate of scheduled payments of principal and interest on home mortgage and consumer debt.

Interest Expense Burden of Nonfinancial Corporations



* Cash flow is defined as depreciation plus retained earnings (book values)

and local governments have improved, as tax receipts have been stronger than expected, but severe financial problems remain in other locales.

With corporate borrowers still relying heavily on financing through capital markets, and depository lending spreads over market rates remaining high, the trend decline in the share of total credit flows provided by depository institutions was extended through the first half of 1993. From the fourth quarter of 1992 to June, bank credit expanded at a 4¼ percent annual rate, only a modest pickup from the sluggish pace of the previous two years. Securities acquisitions accounted for most of the expansion, as loans increased at only a 1¾ percent rate. The growth of bank securities portfolios in part reflects additions to holdings of securitized mortgage and consumer loans; bank financing of consumer spending and real estate transactions is thus stronger than indicated by bookings of loans in those sectors. While commercial and industrial loans have been about flat on balance so far this year, a few signs of easing in bank lending terms and conditions have recently emerged, and business loans rebounded in May and June. Judging by business loan growth at smaller banks so far this year, a pickup has occurred in lending to smaller nonfinancial firms. Thus, the continuing weakness in overall business loan growth does not appear to be driven primarily by restrictive supply conditions, but rather by the preference of larger firms to fund through capital markets.

Lower market interest rates over the past few years have helped strengthen the financial positions of banks and thrifts. The lower rates have resulted in capital gains on securities and improved interest margins—as deposit rates have fallen more than lending rates. Lower rates also have helped bank borrowers by decreasing interest expenses and boosting economic activity, thereby reducing loan loss provisions for banks. Banks posted record earnings in 1992 and remained very profitable in early 1993; prices of their shares on equity markets have risen substantially.

Thrift institutions have continued to contract in 1993, though at a much slower pace than over the last four years. A lack of funding for the Resolution Trust Corporation caused a hiatus in the closure of institutions under its conservatorship. However, privately operated thrifts have not expanded and the industry continues to consolidate.

Slower growth in nominal GDP, moderate demand for credit relative to spending, and the reduced share of credit provided by depositories have all contributed to the lack of significant growth in the broad monetary aggregates this year. Another factor inhibiting money growth has been continued substantial funding of bank and thrift assets with subordinated debt and equity issues, as well as retained earnings—all a byproduct of ongoing efforts to build capital positions. While about a third of the industry (by asset volume) had capital ratios and supervisory ratings high enough at the end of 1991 to be considered well-capitalized, more than two-thirds were so positioned by early 1993. About $10 billion was added to bank equity and subordinated debt during the first quarter, about the same pace as in 1992; data on new debt and equity issues indicate another sizable gain over the second quarter.

Depositories have also recently relied more heavily on other nondeposit sources of funds. Weak economies and credit demand abroad have prompted the U.S. offices of foreign banks to draw more funding

Domestic Bank Assets by Capital Category
Adjusted for overall supervisory ratings[1]

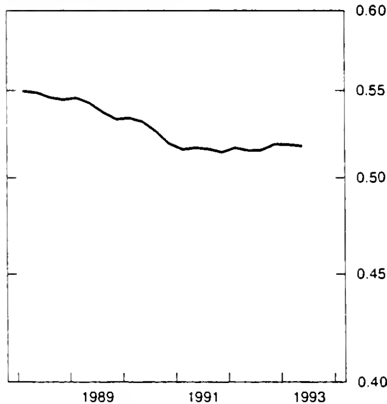
Capital Category	End of Year 1991	End of Year 1992	March 1993
Percent			
Well Capitalized	34	68	70
Adequately Capitalized	45	22	20
Undercapitalized	21	10	10

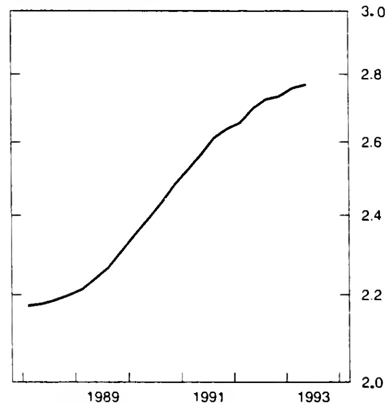
1 Adjustments to capital categories were made according to the rule of thumb of downgrading a bank by one category for low a examination rating by its supervisory agency (CAMEL 3, 4, or 5)

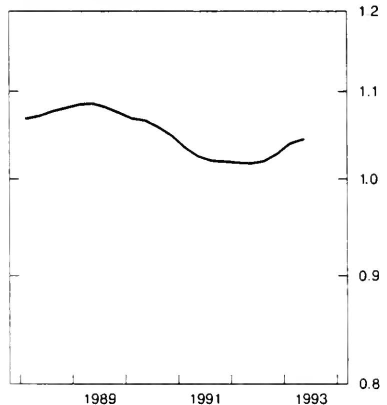
from overseas, and the domestic offices of U.S. banks to reduce foreign lending this year. Overall shifts from deposits to other sources of funding may be driven partly by regulatory inducements—including higher insurance premiums on deposits and incentives to bolster capital. But changes in investor preferences from short-term deposits to longer-term debt and equity may also be playing a role in motivating the restructuring of bank and thrift sources of funds.

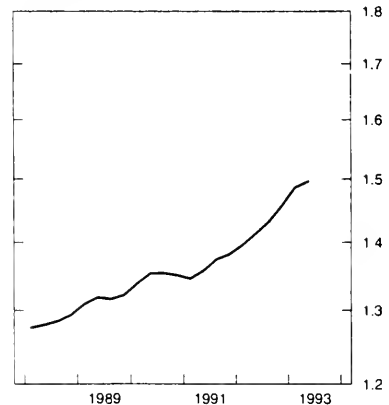
Key elements affecting money growth relative to nominal income may be seen in a decomposition of M3 velocity in the four-panel chart below. The top left panel depicts the moderation in overall borrowing in the economy; after several years of declines, the ratio of nominal GDP to total nonfinancial debt, or debt velocity, has been rather stable since 1990, as debt growth has slowed to about the pace of GDP growth. The top right panel shows the reduced role of

Decomposition of M3 Velocity (Ratio scales)









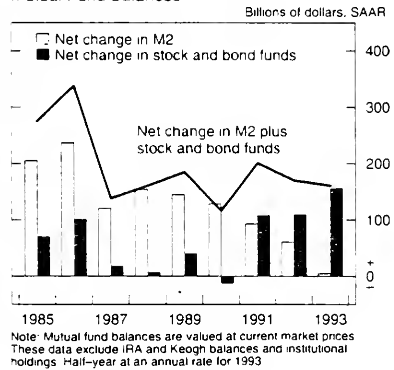
depositories in providing even the more moderate volume of total credit; the ratio of total nonfinancial debt to depository credit has risen sharply over the last three years. Higher costs and attempts to recoup past capital losses led to higher bank loan rates relative to market rates after 1988 and stricter nonprice terms and standards, while declines in long-term interest rates and a strong stock market, along with the impetus to repair balance sheets, induced firms to turn to capital markets for financing. The bottom left panel shows the increased reliance on equity and other nondeposit funding by banks and thrifts, as well as some declines in money market mutual funds; the ratio of depository credit to M3 has been rising since the second quarter of 1992. The velocity of M3 (GDP divided by M3), in the bottom right panel, is the product of the other three ratios. In the late 1980s, M3 velocity departed from its traditional declining trend, increasing at about a 2 percent annual rate as the depository sector began playing a smaller role in financing credit growth. The growth of M3 velocity picked up to 5¼ percent in 1992 and perhaps a somewhat faster rate in the first half of 1993.

Greater reliance by borrowers on capital markets has been facilitated by concurrent shifts in saving preferences away from monetary assets and into capital market investments. Such portfolio realignments are evident in record inflows to bond and stock mutual funds, and money balances were also likely invested directly in stocks and bonds. The incentives for what appears to be an extraordinary adjustment of household portfolios are varied. Interest rates paid on retail time deposits, NOW accounts, and money market deposit accounts (MMDAs) have fallen well below any rate offered since the inception of deregulated deposits in the early 1980s, and savings deposit rates are now the lowest in more than thirty years. The shock effect of historically low deposit interest rates caused many depositors to investigate alternative investments. With the yield curve extraordinarily steep, much higher returns have been available in recent years on longer-term investments. A bond or stock mutual fund offers a chance to earn these higher yields, but still enjoy liquidity features, including in some cases a check-writing facility. However, investment in such a mutual fund carries with it a higher risk of loss as well, because unlike monetary assets, its principal value fluctuates with market prices. Indeed, the higher yield on bonds relative to short-term instruments probably anticipates some capital losses. Whether all households accurately assess relative risks when comparing returns recently earned on mutual funds with those on money balances remains an open question.

Shifts into mutual funds have become much easier and less costly for households, most notably because many banks have begun offering mutual funds for sale in their lobbies. While many banks now offer discount brokerage services, a survey by the Federal Reserve found that larger banks have recently been making special efforts to promote mutual fund investments among their depositors. An increasing number of banks have sponsored their own mutual funds or entered into exclusive sales relationships with nonbank sponsors of funds. Some banks have promoted these products as a defensive measure to retain long-run relationships with valued depositors. In other cases, however, banks have promoted funds as part of a strategy to earn fee income without booking assets, thereby avoiding the need to raise additional capital.

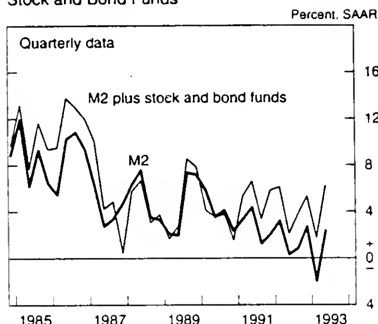
Substitution between money and long-term mutual funds appears to have become evident in the aggregate data in recent years. There was little increase in such funds from 1987 through 1990, but large inflows since then, at the same time that accretions to M2 balances declined. A comparison of the quarterly growth rates of M2 and the sum of M2 and bond and stock funds shows that growth of the sum has not weakened as dramatically as that of M2 over the last two and half years; it has averaged nearly a 5 percent annual rate, compared with less than 2 percent for M2. Although adding mutual funds and M2 together captures some substitution out of M2 in recent years,

Changes in M2 and Stock and Bond Mutual Fund Balances



Note: Mutual fund balances are valued at current market prices. These data exclude IRA and Keogh balances and institutional holdings. Half-year at an annual rate for 1993.

Growth Rates of M2 and M2 plus Stock and Bond Funds



the total remains quite volatile, indicating that other forces have affected both M2 and mutual funds. Partly as a consequence, the relationship of the total to aggregate spending is subject to considerable uncertainty. Investments in bond and stock funds are themselves subject to potentially volatile capital gains and losses. More fundamentally, the responses of the public, now holding vastly expanded mutual funds, to a variety of interest rate and stock price movements has yet to be tested.

Because weakness in the demand for broad money has largely resulted from shifts of portfolio preferences rather than changes in spending intentions, it has not been reflected in comparable weakness in nominal GDP. Furthermore, the effects of a declining share for depositories in overall credit growth have been substantially offset by increased funding through capital markets, where households now invest a larger share of wealth. The velocity of M2 has experienced extraordinary and unpredictable surges, reducing its value as a guide to policy. Traditional models of velocity based on the difference between short-term market interest rates and interest rates on deposits and money market mutual funds, and even broader models that take account of longer-term interest rates and after-tax loan rates faced by households, cannot explain the full 4 percent rise in M2 velocity in 1992, nor what may be a somewhat faster rate of increase in the first half of 1993.

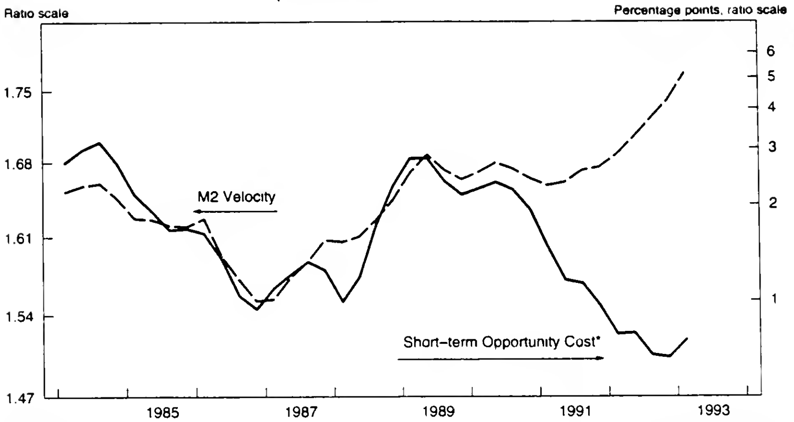
Money growth in the first quarter was depressed in part by the effects of several temporary factors, including distortions of seasonal factors and a lull in mortgage refinancing. A renewed surge of mortgage refinancing began to bolster demand deposits and MMDAs in April, as mortgage servicers increased balances temporarily before making remittances to investors in mortgage-backed securities. The seasonal factor distortions began to reverse that month as well. However, substantial shortfalls in individual nonwithheld tax payments relative to recent years produced an offsetting restraint to money growth in April, as the buildup of balances required to pay taxes was smaller than that incorporated into seasonal factors. Even excluding estimated effects of these special factors, however, underlying growth of money through the first four months of the year was far weaker than historical relationships would suggest.

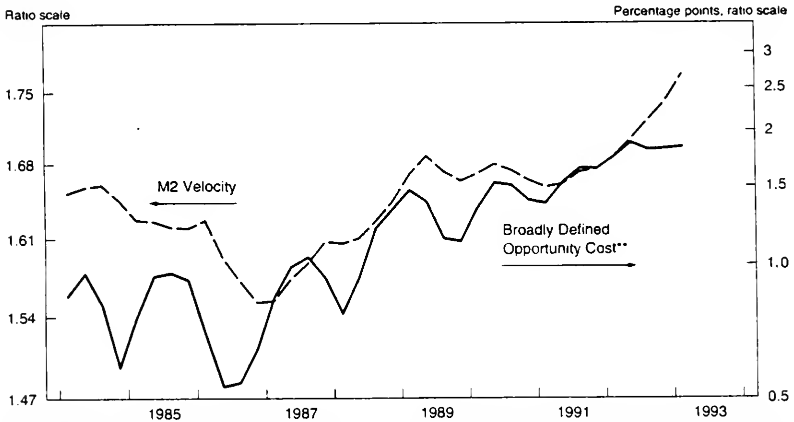
Despite continued heavy inflows to bond and equity funds in May, the monetary aggregates surged, boosted in part by a reversal of the tax effects and an intensification of mortgage refinancing activity. However, the aggregates decelerated substantially in June, and by more than might be suggested by a waning of tax and mortgage refinancing effects.

In 1993, household portfolio adjustments differed somewhat from their previous pattern. In the past, the realignment of household wealth toward capital market investments had mainly involved shifts from money market mutual funds and small time deposit accounts. At the same time, outflows from those accounts had also gone into NOW and savings deposits, the interest rates on which were falling only slowly as market rates declined. This year, the sum of all these M2 balances has fallen at about the same rate as in 1992, but a slower runoff of small time deposits and money funds has been offset by a sharp deceleration in the growth of NOW and savings deposits. Catch up declines in interest rates on liquid deposits may account for part of their slower growth. Some nontransactions balances held in NOW and MMDA deposits have likely been shifted into bond and equity funds. It may be that some depositors who do not ordinarily shop for small rate advantages have been induced to make basic portfolio adjustments because of the historically low deposit interest rates and the increased ease of making investments in capital market instruments.

Partly as a result, narrow measures of money have decelerated this year, but their expansion has remained rapid. M1 has grown at a 9½ percent rate from the fourth quarter of 1992 through June, compared with 14¼ percent in 1992. Reserves, now held exclusively against transaction deposits, have grown at an 11 percent pace compared with 20 percent in 1992. The monetary base has slowed by much less,

M2 Velocity and Opportunity Cost





Note Opportunity costs are two-quarter moving averages
*3-month T-bill rate less weighted average rate paid on M2

**Estimated difference between a weighted average of competing rates (3-month T-bill, 5-year T-note, after-tax auto loan rate) and a weighted average of rates paid on M2 components.

because of continued strong foreign demand for currency this year.

With reduced strength in its M1 component, and in savings and MMDAs, as well as continued runoffs of small time deposits and retail money funds, M2 has grown at only a ¾ percent annual rate from the fourth quarter of 1992 through June 1993, well below the lower end of its growth cone set in February. The FOMC monitored the behavior of M2 carefully over the first half of the year, but in light of actual and expected strength of velocity, determined that actions to boost M2 growth were not needed to achieve the Committee's underlying objectives for prices and the

economy. The aggregate is near the lower arm of the revised annual growth cone established in July, and if velocity continues to increase substantially, M2 may well come in toward the lower end of the revised growth range for the year.

The non-M2 portion of M3 has declined this year at nearly the same pace as the previous two years. Large time deposits have continued to fall, and the halt in reductions in short-term rates has ended the rapid growth of institutional money funds, as their slower-adjusting yields have come down to their usual relationship to market interest rates. From the fourth quarter of 1992 through June, M3 fell at about a ¼ percent annual rate; it lies slightly below its revised annual growth cone.

Growth of Money and Debt

		M1	M2	M3	Total domestic nonfinancial debt	Nonfederal domestic nonfinancial debt
Annually, fourth quarter to fourth quarter				*(Percentage changes)*		
1980		7.4	8.9	9.5	9.5	9.0
1981		5.4 (2.5)[1]	9.3	12.3	10.0	9.7
1982		8.8	9.1	9.9	9.3	7.4
1983		10.4	12.2	9.9	11.4	8.8
1984		5.5	8.1	10.8	14.3	13.9
1985		12.0	8.7	7.6	13.8	13.3
1986		15.5	9.3	8.9	14.0	13.7
1987		6.3	4.3	5.8	10.1	10.4
1988		4.3	5.3	6.4	9.2	9.6
1989		0.6	4.7	3.7	8.2	8.5
1990		4.3	4.0	1.8	6.8	5.9
1991		8.0	2.8	1.1	4.4	2.5
1992		14.3	1.8	0.3	4.8	2.9
Semiannually (annual rate)[2]						
1993	H1	8.7	0.1	-0.7	5.1	3.3
Quarterly (annual rate)[2]						
1993	Q1	6.6	-2.0	3.8	4.4	3.0
	Q2	10.6	2.2	2.4	5.7	3.6
Fourth quarter 1992 to June 1993 (annual rate)		9.5	0.8	-0.3	5.1[3]	3.3[3]

1 Adjusted for shift to NOW accounts in 1981
2 From average for preceding quarter to average for quarter indicated
Second quarter debt aggregates estimated on data through May
3 1992 Q4–1993 May for debt aggregates

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ALAN GREENSPAN

Q.1. Your testimony indicates that you plan to focus your monetary policy more on real interest rates. You stated, "the equilibrium term structure of real rates cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy." The purpose of this hearing was to have you express your plans and objectives more specifically. Would you tell us:

(a) How are you measuring real interest rates? **(b)** What do you think the equilibrium term structure of real rates is? **(c)** What is your strategy for adjusting real interest rates relative to equilibrium rates over the next 18 mouths?

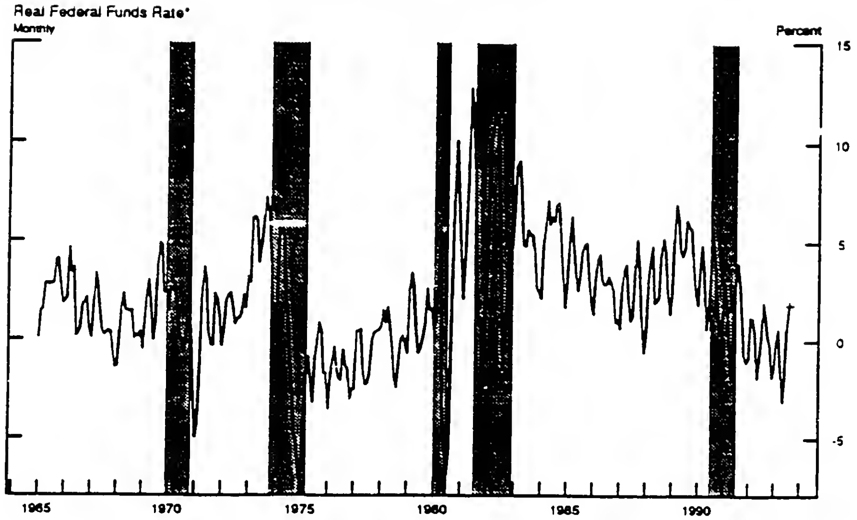
A.1. The real rate of interest is defined as the nominal interest rate less the expected rate of inflation. Several complications arise in measuring and using real interest rates. First, a number of real interest rates probably have individual significance for various types of spending. These real rates correspond to the variety of financial instruments, which differ by term to maturity, duration, credit quality, liquidity, taxability, call options, and other features. Any single real rate is an imperfect proxy for all real rates. Second, there are no direct, unambiguous measures of the expected inflation embodied in nominal interest rates. Consequently, analysts are forced to rely on survey-based measures of inflation expectations, which may be subject to various biases, or on actual inflation data, in which case analysts must assume that households and businesses base their expectations on recent experience with inflation.

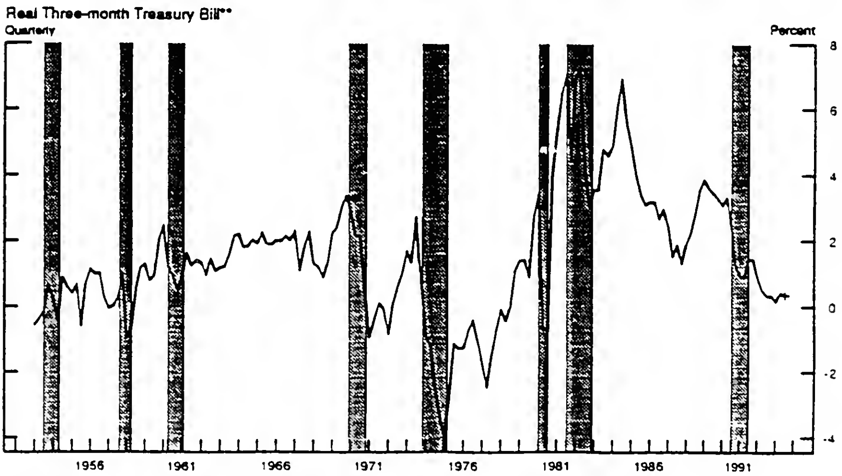
Equilibrium real rates are defined as the interest rates that, if maintained, would result in full employment and constant inflation. More broadly, an entire structure of equilibrium real interest rates can be defined, with the elements of the structure corresponding to the various real interest rates alluded to in the previous paragraph. For example, term premiums will lead to differences between equilibrium short-term real rates and equilibrium long-term real rates, and default premiums will cause differences between equilibrium rates on corporate bonds and equilibrium rates on Treasury bonds. A complicating factor relating to the use of equilibrium real rates is that they may vary over time in response to changes in underlying influences such as desires to save, changes in technology affecting productivity, non-interest-rate terms of credit, and fiscal policy. A central bank needs to take account of these variations in conducting monetary policy.

The following charts provide selected measures of real interest rates; the various series use short- and long-term nominal rates combined with measures of inflation expectations that are based either on survey data or on recent actual inflation. The various measures of short-term real rates show similar movements, as do long-term real rates, but they display appreciable differences in their levels. Generally, the charts indicate that real interest rates are at the lower ends of their ranges since the late 1970's.

Chart 1

Short-term Real Interest Rates

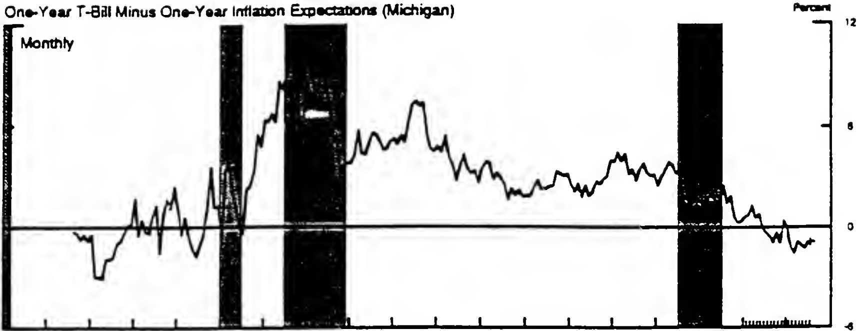


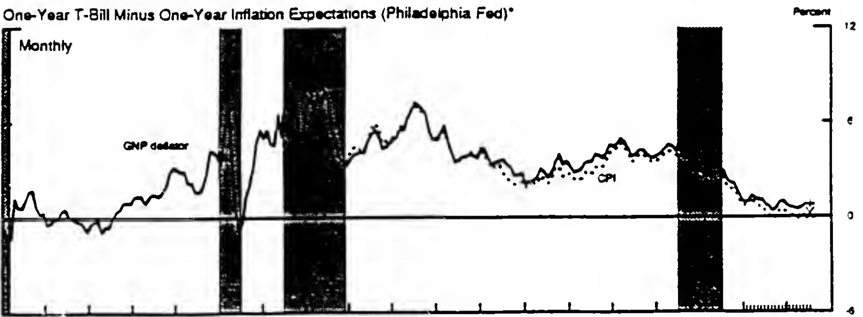


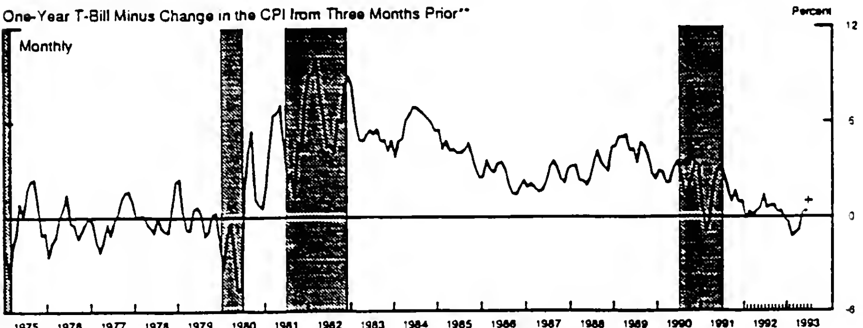
* Federal Funds rate minus three-month moving average of past inflation as measured by the CPI less food and energy
** Three-month bill rate on a coupon equivalent basis less a four-quarter moving average of past inflation, as measured by the PCE deflator
+ Denotes most recent values using latest available inflation data.

Chart 2

One-Year Real Interest Rates







* ASA/NBER quarterly survey until 1990 Q1; Philadelphia Federal Reserve Bank survey thereafter. Monthly T-bill rates less most recent quarterly inflation expectation.

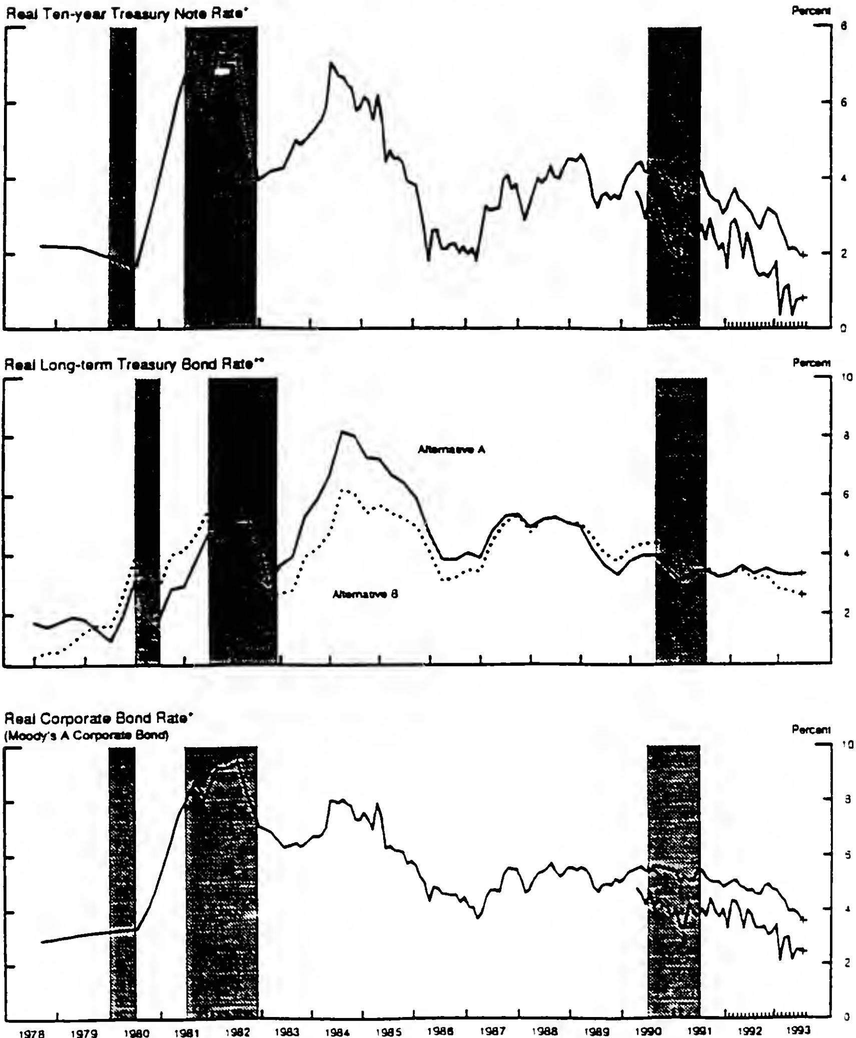
** CPI defined to exclude food and energy.

Note: T-Bill is on a coupon-equivalent basis.

+ Denotes most recent weekly T-bill rate less most recent inflation expectation.

Chart 3

Long-Term Real Interest Rates



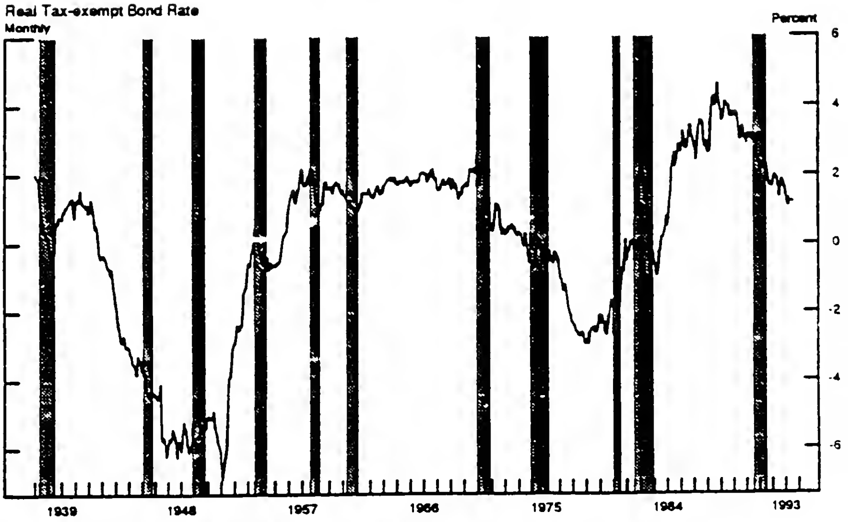
* The upper line measures 10-year inflation expectations by the Hoey survey until April and the Philadelphia Federal Reserve Bank survey thereafter. Lower line uses Michigan 5 to 10 year inflation expectation.

** Alternatives A and B: Expected inflation is measured by a 12- and 20-quarter moving average of past inflation (PCE deflator), respectively.

+ Denotes most recent weekly value using latest available inflation data or expectation.

Chart 4

After-tax Real Rate of Interest*



* Moody's AAA Municipal Bond Yield less last five years of CPI inflation.
+ Denotes most recent value, using latest available inflation data.

Not only actual but equilibrium real rates probably have shifted over the last fifteen years. In the first half of the 198O's, for example, substantial fiscal stimulus likely increased equilibrium real rates. By the early 1990's, however, a number of forces were restraining spending, including the efforts of households, businesses, and financial institutions to strengthen their balance sheets, which had become strained during the previous decade by heavy reliance on debt. It was in view of these forces that the Federal Reserve took measured actions over the past few years to lower short-term real interest rates to historically low levels, encouraging a gradual downward trend in long-term interest rates and abetting the process of balance-sheet adjustment. As this adjustment has progressed, the restraint on spending has eased somewhat; still, attitudes toward credit remain quite cautious and recent legislation confirms that Federal fiscal policy will continue to be moderately restrictive. For these reasons, it is possible that the equilibrium structure of real interest rates is now somewhat lower than we have experienced for many years.

Nevertheless, a range of experience in a variety of economic situations strongly suggests that the current real short-term interest rates of about zero are below the levels toward which they ultimately will need to move to be consistent with achievement of the Nation's economic objectives over time. A lesson of the 1970's was that maintaining very low real short-term rates for long periods of time is likely to be incompatible with stable economic conditions. When and by how much real short-term interest rates will eventually need to rise will depend on economic developments and inflation pressures. In any case, it is worth noting that a change in real interest rates does not necessarily imply a commensurate movement in nominal interest rates; real interest rates can rise either because nominal rates increase or inflation expectations decrease.

Particularly in view of the current unreliability of the monetary aggregates, the Federal Reserve must monitor a wide range of variables in assessing economic trends and inflation pressures. Although estimates of real interest rates (and their equilibrium values) are subject to considerable uncertainty, they have considerable economic significance and can usefully be included in the indicators employed in conducting monetary policy.

Q.2. The situation in the economies of Europe and Japan appears poor and deteriorating. Unemployment in Europe is the highest since World War II. How serious is the risk that these economies will remain depressed for some time or weaken significantly more and what are the potential consequences for our economy?

A.2. Economic activity in Europe and Japan has been quite weak on average since early 1992. However, the experiences of individual countries have differed; for example, in the United Kingdom recession started in late 1990 and recovery has already begun, while in western Germany recession began in mid-1992 and recovery is not yet clearly established. Unemployment rates are very high in Europe, but in many European countries rates are below those in the 1982–1983 recession. Activity is likely to recover only moderately in Europe and Japan during the remainder of this year and next. Moreover, there are risks that even a weak recovery will prove elu-

sive. Such an outcome could result from consumer confidence remaining depressed, from lackluster business spending as a result of slow credit growth or weak profits, or, in some countries, from the further effects of falling commercial and residential property values. Continued slow growth in Japan and our European trading partners would lessen demand for U.S. goods and services. However, much of the recent growth in U.S. exports has been to other parts of the world, such as East Asia, Mexico, and Canada. Strong economic growth in these areas—or continued recovery in the case of Canada—should help to sustain growth our exports.

Q.3. Recently we had some dramatic revisions in the employment data. You have raised concerns about bias in the inflation data. These are critical data series which you use in making your policy decisions. Are we providing the best data we can? What should we be doing to improve these data?

A.3. The quality of economic statistics has been a longstanding concern of the users of such data, both within the Federal Government and in the business community. In 1989, a working group consisting of the producers and users of economic statistics in the Federal Government put forth a program designed to address such concerns, by improving the quality of Government statistics. This so-called "Boskin initiative" resulted in a package of high priority projects that included, among other things, improving the existing labor market surveys and developing new techniques to incorporate quality adjustment in price indexes.

The statistical agencies have, within the limits of their budgets, been successful in addressing the concerns raised by the working group on statistics. For example, the Bureau of Labor Statistics (BLS) has succeeded in raising response rates for the first estimate of monthly employment growth from 35 percent in the mid-1980's to 85 percent in 1992. Consequently, the initial revision to the employment estimate has fallen from an average of nearly 60,000 (without regard to sign) between 1981 and 1990 to about 35,000 in 1991 and 1992. Similarly, the Bureau of Economic Analysis has made considerable progress in incorporating better estimates of computer prices into the National Income and Product Accounts. Such estimates will not only improve measures of Gross Domestic Product, but will also lead to better estimates of inflation and productivity. Some progress has been made as well in improving statistics on the growing service sector, where there previously had been a shortage of useful data.

Nonetheless, there is considerable room for further improvement. As you point out, there have been some sizable revisions in the payroll employment figures recently. One notable example was the upward revision to employment growth from April 1992 through the end of last year. This upward revision reflected judgmental adjustments to the bias adjustment factors used by the BLS to estimate employment changes in establishments systematically not covered by its sample (mostly births and deaths of establishments.) Although the adjustments to the bias factors were based on preliminary information from unemployment insurance tax data, the judgmental nature of revision suggests that strengthening this part of the estimation procedure might have a high payoff.

Of course, the statistical agencies generally are well aware of weaknesses in their methodology (of which the BLS bias adjustment methodology is just one example), and most agencies have under way limited research programs to attempt to improve their statistical series. Unfortunately, however, these agencies generally do not receive sufficient funds from Congressional appropriations to undertake major improvement programs. Given the extensive use of these data by policymakers and others, the potential benefits from an increase in funding for Federal statistical agencies would likely be quite large but, of course, such an initiative would have to be weighed against other objectives in the context of the current tight budgetary situation.

Q.4. Over the past 2 years, banks have improved their capital ratios considerably, and continue to benefit from low short-term interest rates and steep yield curves. Yet securities holdings at banks continue to rise and business loan volume continues to shrink. Is the credit crunch still an important factors in the economy? If so, what is driving it?

A.4. The marked weakness in business loan growth over the last few years has reflected several factors. Overall demand for credit by businesses has been weak, as internally generated cash flows have tended to exceed expenditures on investment and inventories. Also, businesses in the process of strengthening their balance sheets have used the proceeds of bond and equity issuance to pay down bank loans and other types of short-term debt.

In addition, banks restricted the availability of credit by tightening their standards and terms for business lending in 1990 and 1991. However, surveys and other information suggest that banks had largely ceased tightening lending standards by late 1991 and lending terms during 1992. Some modest signs of easing emerged in 1992. Over the past six months or so, banks appear to have eased terms and standards somewhat more aggressively and consistently. During this period, the runoff of business loans that had characterized 1991 and 1992 appears to have about ceased, and loans have expanded on balance over the past three months. This pickup may reflect a turnaround in the relation between businesses' internal cash flow and expenditures, as well as the easing of banks' lending terms and standards.

Nevertheless, credit remains more costly and more difficult to obtain for small- and medium-sized businesses than it was several years ago. Despite some recent easing, banks' standards for extending credit remain high, no doubt reflecting a chary attitude stemming from large loan losses during the recessions. Moreover, banks' efforts to maintain higher capital ratios, partly in response to market pressures, recent legislation, and forthcoming regulations, likely are prompting banks to continue to require wider spreads over funding costs than they have historically during economic expansions.

Prudent attitudes toward credit on the part of both lenders and borrowers are appropriate and welcome, but adequate credit availability is essential for economic growth. The Federal Reserve continues to work with the other Federal banking agencies to ensure

that regulatory and supervisory practices are not inappropriately inhibiting the extension of credit.

Q.5. On July 15, President Clinton asked the bank and thrift regulators to reform the enforcement process for the Community Reinvestment Act. The goal is to increase CRA's effectiveness by emphasizing performance rather than process, improving examination quality, and stepping up sanctions against institutions with consistently poor performance. Have the regulators begun this process? Can you share with us your views on where the process might lead us?

A.5. Yes, the regulators have begun reviewing the Community Reinvestment Act, the regulations that implement the act, and the supervisory enforcement process. We are currently seeking opinions from the public on how to make the CRA supervisory process more effective. To facilitate this process, the Federal regulatory agencies are holding a series of public meetings concerning CRA around the country in August and September. These meetings will be held in: Washington DC, San Antonio, Texas, Los Angeles, California, Albuquerque, New Mexico, New York City, Henderson, North Carolina, and Chicago, Illinois.

In addition to the public meetings, the agencies also have met with banking organizations and community groups. The purpose of the meetings is to gather ideas on improving the regulations that implement CRA and the examination process. Information obtained in the meetings will be used in our work to reform the CRA regulations and the supervisory process to increase community reinvestment and eliminate necessary paperwork.

Q.6. Despite increased attention by banking regulators in recent months to the problem of credit discrimination, in the first half of 1993, 93 percent of banks and thrifts rated under the Community Reinvestment Act got one of the top two grades. How do you account for these high ratings given the Boston Fed study and other evidence of unequal access to credit?

A.6. A bank's compliance with fair lending laws is certainly reflected in its CRA rating. In fact, a bank's CRA record is evaluated in terms of 12 assessment factors, two of which deal directly with discriminatory practices. Of course, discriminatory practices would in all likelihood adversely affect a bank's CRA rating.

While it is true that the majority of our banks presently have satisfactory or outstanding CRA ratings, we attribute these high ratings, at least in part, to the positive effect our specialized consumer affairs examinations have had on our banks. Since 1979, the Board has had a specialized consumer compliance program and specially trained compliance examiners, separate from our safety and soundness responsibilities. As part of the CRA examination process, Federal Reserve examiners not only look for weaknesses in a bank's CRA program and make recommendations for improvement, but also strive to educate bank personnel in the administration and implementation of an effective program. This process occurs even in cases where banks are rated satisfactory or better and extends beyond the regularly scheduled CRA examination.

For example, System examiners provide banks with technical assistance through one-on-one conversations, advisory visits, and by

speaking at industry functions. In addition, each Federal Reserve Bank has a Community Affairs department which works directly with State member banks to provide technical information on community development and related programs.

The frequency of examinations also fosters satisfactory CRA performance. A bank rated "satisfactory" for CRA is examined approximately every 18 months. In contrast, the examination cycle for a bank rated "needs to improve" is shortened to approximately 12 months, and for a bank rated "substantial noncompliance" is shortened even further to a 6 month period.

The Board does not condone credit discrimination and will not tolerate its appearance in any State member bank. Over the last year, we have undertaken a number of initiatives to strengthen our fair lending examination process. One of these initiatives includes a new procedure which utilizes a computer program and a regression analysis to assist with our fair lending evaluation. Specifically, the computer program will help select for review minority and nonminority applicants with comparable credit characteristics, but whose loan applications may have been treated differently during the loan granting process. While a comparison of minority and nonminority applicants has been a major part of our procedures in the past, our samples have always been selected manually. We believe that the computer program will enable us to look at more applicants quickly and result in a better loan sample for the fair lending portion of the examination.

Q.7. I was encouraged that the four regulatory agencies recently issued a statement that described stepped up efforts to combat lending discrimination. These efforts included increased examiner training and use of statistical analysis—two improvements I have advocated. But there was no mention of using testers, which has been endorsed by the Office of the Comptroller of the Currency but opposed by the Federal Reserve. Why does the Fed continue to oppose the use of testers to ferret out lending discrimination when we use them successfully to combat housing discrimination?

A.7. As you have noted, the Board of Governors and the other regulatory agencies have been working to strengthen our fair lending enforcement program. In fact, the Board carefully considered a pilot mortgage testing project in 1991 and decided not to pursue it. While we understand that some government agencies have documented the testing methodology in fair housing enforcement, nevertheless, the Board believes there would be substantial difficulties in using testing to detect mortgage credit discrimination.

The Board has been concerned that using the testing methodology to examine the mortgage application process is likely to be very expensive, creates research problems not present in testing for housing discrimination, and involves other difficulties. We understand, however, that HUD and the OCC have plans to do a pilot in this area. We will be very interested in the results of this pilot.

Q.8. The latest report of the Savings Association Insurance Fund Industry Advisory Committee quotes senior FDIC officials as saying that failure of Congress to provide supplementary funding to the SAIF would require deposit insurance premiums for thrifts to exceed premiums for banks by 15 to 20 cents per hundred dollars

within a few years. The FDIC officials concluded that maintenance of such differentials for a period of several years would virtually eliminate the thrift industry. Do you agree?

A.8. As the clean up of troubled and insolvent thrifts nears completion through the efforts of the RTC, the thrift industry is regaining its footing and may be on the way to more stable conditions. Return on assets in the first quarter (excluding thrifts taken over by the RTC) was 0.96 percent compared to 0.53 percent for the full year 1992. Recent profitability, however, was aided by low interest rates and a favorable yield curve.

It would be unfortunate then if that fragile recovery were impeded by a significant actual (or potential) differential between BIF and SAIF deposit assessment rates. The current BIF and SAIF average assessment rates are both at the historically high level of approximately 25 basis points. The banking industry (BIF-insured commercial banks and savings banks) was recently forecast by the FDIC to experience a reduction in the assessment rate of 14 basis points in four to six years. Given the intense competitive pressures facing the banking industry, such a reduction would help the industry attract capital and remain competitive both domestically and internationally.

In contrast the savings and loan industry, also facing intense competitive pressures, is forecast to receive a 2 basis point *increase* in the assessment rate and to remain at that level for at least 20 years. This phenomenon is largely the result of the unfunded commitment to the Financing Corp (FICO) [1] that currently consumes about 40 percent of SAIF assessment revenue (accounting for 10 out of 25 basis points of the assessment rate.) That commitment runs through the year 2019 and is estimated by the FDIC to have a present value cost of over $8.5 billion. Even if the SAIF were given the resources to be fully recapitalized at the same time as the BIF, SAIF assessment rates (applied to the current level of insured deposits) would presumably need to be 10 basis points higher than BIF to cover these FICO payments.

If adequate funds are not appropriated for the SAIF, it is likely that SAIF member institutions would operate at an ongoing disadvantage to other financial concerns and consequently would be less able to attract capital and to maintain their financial health. If it becomes clear that surviving SAIF-insured thrift institutions win be responsible, not only for recapitalizing SAIF from its near-zero net worth level, but also for the ongoing FICO payments, these institutions would have strong incentives to convert to the BIF or reduce their reliance on insured deposit funding by whatever means available.

Currently, there is a moratorium on institutions converting from one insurance fund to the other. That moratorium, as specified under FIRREA, is scheduled to expire in August of 1994. For the past four years, bank holding companies have been allowed, under certain circumstances, to acquire thrift institutions and convert their deposit insurance from SAIF to BIF. However, FIRREA also

[1] FICO was created by the Competitive Equality Banking Act of 1987 to recapitalize the FSLIC through the issuance of bonds to the public. As provided for by FIRREA, FICO has an ongoing claim on SAIF assessments through the year 2019 to fund interest payments on FICO bonds.

specifies that converting institutions must pay exit and entrance fees to the insurance funds.[2] How the thrift industry will be affected by a BIF/SAIF premium differential will to some extent depend on whether the FIRREA moratorium on SAIF to BIF conversions is allowed to expire and the magnitude of entrance and exit fees set by the FDIC at that time.

If the moratorium is extended, the SAIF assessment base still seems likely to decline, as SAIF members take steps to reduce their assessments. This could be done by reducing their reliance on insured deposits in favor of alternative funding sources such as Federal Home Loan Bank advances or repurchase agreements. Institutions may also attempt to offset SAIF premiums with riskier, high yielding assets that may ultimately increase SAIF insurance losses. An eroding assessment base or higher insurance losses would require the FDIC to raise SAIF assessment rates even higher, further contributing to the erosion of the assessment base. At some point, assessment rates might be high enough to threaten the competitiveness and effective viability of marginal institutions. While the assessment rate differential in itself might not be large enough to eliminate the industry, the ongoing burden of the SAIF on the savings and loan industry would act to encourage industry shrinkage and capital divestment.

If the moratorium is allowed to expire next year, the SAIF assessment base will also be affected by those thrifts that elect to leave the SAIF by abandoning savings and loan charters in favor of savings bank or commercial bank charters.[3] However, as a practical matter, the number of conversions may be limited by several factors, especially the size of SAIF-to-BIF exit and entrance fees. The BIF entrance fee is set at the ratio of BIF's net worth to insured deposits. Currently small at 5 basis points, the BIF entrance fee will grow to as much as 125 basis points of insured deposits as the fund recapitalizes.[4] The SAIF exit fee is currently 90 basis points and is determined jointly by the FDIC and Treasury. In making a SAIF-to-BIF conversion decision, institutions will gauge whether the assessment rate differential between funds represents a greater present value cost than paying entrance and exit fees today.

Other factors affecting conversion rates include the adequacy of an institution's supervisory rating or ownership restrictions (e.g., commercial and industrial companies may own savings and loans but not banks.) In addition, other institutions may conclude that the benefits of a savings and loan charter (i.e. interstate branching rights) outweigh the assessment rate differential.

In any event, it seems likely that some thrifts, especially well-run, well capitalized thrifts would be able to convert. A migration

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[2] Under the "Oakar" amendment to FIRREA, entrance and exit fees could be avoided by BHCs through the payment of SAIF premiums on a hypothetical SAIF deposit bare after the merger. There were approximately $80 billion in Oakar deposits as of December 31, 1992. In addition, thrifts simply wishing to convert to a commercial bank charter could maintain SAIF insurance through the "Sasser" amendment.

[3] The conversion of a savings and loan charter to a commercial bank charter may be complicated by the IRS requirement for the recapture of past bad debt income tax deductions that are available for thrifts and savings banks but not for commercial banks. For some institutions, the resulting tax liability might be too large. Some institutions might choose therefore to convert to a state savings bank charter to avoid this potential tax liability.

[4] As of June 30, 1993, the net worth of the fund was calculated to equal $6.8 billion or 35 basis points of insured deposits. An entrance fee of 35 basis points should become effective soon.

of such top quality thrifts arguably could leave SAIF with poorer quality institutions and higher insurance losses relative to the assessment base. In addition, the combination of high entrance and exit fees and high SAIF assessment rates would probably discourage BIF-insured institutions from acquiring marginal thrift institutions and result in higher SAIF insurance losses.

Therefore, even if SAIF receives fees large enough to satisfy an exiting thrift's share of the FICO obligation, the remaining SAIF-insured institutions would still have to shoulder the remaining FICO burden and the possibility of proportionally higher insurance losses. The higher assessment rates needed to offset an eroding assessment base in both size and quality could undermine the long term viability of institutions that are forced to remain SAIF-insured.

Q.9. This Committee has heard highly disturbing testimony concerning mortgage discrimination and the related problem of reverse redlining. I had previously asked that the Federal Reserve conduct field hearings to examine these important issues, but have yet to receive a response. Will the Federal Reserve hold regional hearings on mortgage discrimination and reverse redlining?

A.9. The Federal Reserve, along with the other financial regulators, will be holding a series of public meetings around the country in August and September to listen to the opinions of community groups, financial institutions, as well as the general public, on how we can better implement the CRA. We expect the topics of mortgage discrimination and reverse redlining will be addressed at these meetings.

Q.10. The United States gives foreign banks and securities firms the same competitive opportunities in our financial markets as domestic firms enjoy. On July 21, in testimony delivered before the House Foreign Affairs committee, Under Secretary of the Treasury Larry Summers testified about the U.S./Japan Framework discussions. Speaking on Japan's financial services market he stated: "Access to financial markets for outsiders, whether they be foreign or Japanese entrants is effectively limited. . . . The end result is that U.S. firms, which are world class competitors in other markets, cannot break into the Japanese market."

He further noted that the Treasury Department has been negotiating with Japan about this matter for 10 years. At his own confirmation hearing Secretary of the Treasury Bentsen voiced concerns about foreign countries that take advantage of our open financial markets, yet do not give us a fair opportunity to compete in theirs. He stated, ". . . the touchstone of our trade policy, including international negotiations on financial services, is that we must demand reciprocity." (a) Do you agree with Secretary Bentsen on this point? If not, why not? (b) Do you think our negotiating position to open foreign financial markets on behalf of U.S. firms would be improved if we enacted the Fair Trade in Financial Service Act, a bill passed by the Senate several times, under which U.S. authorities *could* deny applications from firms whose home countries discriminate against U.S. firms?

A.10. It is unfortunately the case that financial markets in most countries are not as open to foreign financial institutions as are

U.S. markets or as we would like. Efforts have been ongoing for years, bilaterally and multilaterally, involving both the U.S. Treasury and the Federal Reserve, to ensure fair treatment for U.S. firms in foreign financial markets. Significant progress has been made—indeed, I believe more than often is recognized—but more is needed.

In this context, the public policy issue is not whether further liberalization of foreign financial markets is desirable—it surely is—but rather how best to achieve that objective. The Federal Reserve's position has been clear. We believe that the policy of national treatment, which is embodied in the International Banking Act of 1978 and is the principle underlying international policies in the areas of investment and trade in financial services, has served us well. Because we permit foreign institutions who are able to provide financial services in our market in a safe and sound manner to do so, U.S. financial markets are the most efficient, innovative, and sophisticated in the world. Private and public consumers of financial services in this country have benefited greatly as a direct result of that policy. It would be unwise in our judgment to jeopardize such clear benefits by abandoning our current policy in favor of a policy of reciprocity, even if the latter might potentially add to pressure on other countries to open their own markets further.

Instead, the Federal Reserve believes that the United States should continue to impress upon other countries that liberalization of their financial markets is a necessary element of a broadened trading system. The ongoing Uruguay Round negotiations on trade in financial services are an important element of that strategy.

I am confident that further liberalization of foreign financial markets will take place because, ultimately, it is in the countries' own interests, not just the interests of others, for them to open their markets further and because foreign authorities will come to recognize this fact. While the pace of liberation might be slower than we would like, that does not in our judgment justify the enactment of the Fair Trade in Financial Services Act with all the costs and risks such legislation would entail both for U.S. consumers of financial services and for the existing participation of U.S. financial firms in markets abroad.

Q.11. President Clinton has made reducing our overall trade deficit with Japan an important goal, that is why he is pursuing this matter as a top priority in the U.S./Japan Framework discussions. Do you agree that reducing that deficit by expanding opportunities for U.S. exports in Japan is an important ingredient to the economic growth strategy we are pursuing at home?

A.11. Any progress in opening markets abroad where barriers to U.S. exports exist would be beneficial to both U.S. exports and the growth of U.S. output. The U.S./Japan Framework discussions could prove useful in this regard to the extent that they help to improve the access of internationally competitive U.S. exporters in such sectors as telecommunications, financial services, and Government procurement in general. However, the benefits are not likely to be large in macroeconomic terms. Indeed, we cannot depend on developments in any one foreign market to resolve our trade imbalance and spur economic growth at home. Far more important will

be the headway that is made in stimulating our own national savings rate, particularly by reducing the government budget deficit.

Q.12. I understand that officials from the Federal Reserve's staff regularly participate in the GATT discussions on financial services. On July 2 Senators D'Amato, Sasser and I wrote to President Clinton expressing our concerns about the status of the draft GATT test governing financial services. Our concern was that under that text, which operates under the MFN principle, the United States could "lock" its markets open while losing the authority to pursue bilateral negotiations with countries that discriminate against our financial services industries. (a) Are you familiar with this issue? (b) If not, will you familiarize yourself with it and ensure that your staff works to prevent free-riders in these GATT negotiations on financial services?

A.12. Federal Reserve staff worked closely with the Treasury Department to provide technical assistance in the GATT negotiations on a regular basis in 1989 and 1990 and attended negotiating sessions during that time. Since 1991, staff have participated less frequently in the negotiations themselves although they have provided assistance to the Treasury when requested.

I am familiar with the fact that, under the proposed General Agreement on Trade and Services (GATS) text, the principle of "most-favored-nation" (or MFN) would apply to an signatories to the agreement. Under this principle, a party could not favor the firms of any one country in allowing entry or operations without extending the same benefits to firms of an countries that are parties to the agreement. As your question indicates, it has been stated that the application of the MFN principle would allow some countries to take advantage of the open access to the U.S. market without making similar open commitments for their own markets ("free-riding".)

Federal Reserve staff have not been directly involved in Uruguay Round negotiating sessions on MFN issues as they relate to so-called "free-riders." It is my understanding that there will be a major effort, on both a bilateral and multilateral basis, to obtain additional market access commitments from other countries in the coming months of the Uruguay Round negotiations. Federal Reserve staff is prepared to provide whatever assistance it can to the U.S. Government negotiators on financial services.

Q.13. Dennis Encarnation, a professor at the Harvard Business School, has "written a book about the U.S./Japan economic relationship entitled *Rivals Beyond Trade*. In this book he argues a major reason for Japan's persistent trade surplus with our country is related to the gross imbalance in direct investment. Japan, he argues, followed policies of restricting U.S. investment in their country while its firms expanded their investment here. Japanese direct investment in the United States is almost four times as great as U.S. investment in Japan—$87 billion versus just $23 billion. As a result, two-thirds of all American imports from Japan are shipped "intra-company," i.e. from Nissan to its American subsidiaries, while the U.S. does not benefit from such "intra-company" trade into Japan.

Do you think this point made by Mr. Encarnation about the relationship of investment and trade has merit? If so, what sort of policies should we adopt to get at this problem?

A.13. Dennis Encarnation argues that Japanese firms have reaped substantial advantages from past government regulations and the current industrial structure—factors that have served to limit access of U.S. and other foreign competitors to the Japanese market. According to Encarnation, the relevant concept of market access must include direct investment as well as import penetration, particularly since a large part of international trade in manufactured goods involves transactions between affiliated companies. Encarnation maintains that U.S. exports to Japan have been limited by the relative absence of U.S. direct investment in majority-owned affiliates in Japan.

Extensive studies of U.S. direct investment abroad do support Encarnation's argument that direct investment abroad and U.S. exports tend to be positively related. However, these studies, by and large, would suggest the net effect is not very large; production by the foreign affiliates of U.S. companies can substitute for U.S. exports as well as expand their market share. As Encarnation himself points out, the competitiveness of U.S.-based firms and the competitiveness of the United States as a production location need not move in unison. During the first half of the 1980's, U.S. multinational firms largely maintained their shares in world markets through growing sales from their affiliates abroad while the U.S. balance of trade deteriorated sharply.

Appropriate U.S. policies to improve access of U.S. firms to the Japanese market would include encouraging the Japanese government to remove the remaining vestiges of government policies that discourage foreign direct investment in Japan. Features of Japanese industrial structure, such as cross-ownership of shares and tight buyer-supplier relationships, present a more difficult problem.

However, it should be remembered that the overall trade balance of a country largely reflects macroeconomic factors, in particular, the balance between domestic investment and national savings. As long as Japanese saving greatly exceeds domestic investment, Japan's trade surpluses will persist. Increased U.S. direct investment in Japan could improve the U.S. trade balance only if it altered the U.S. savings and investment balance.

Q.14. You state on page 14 of your prepared testimony: "In some markets where American firms were losing share just a few years ago, we have regained considerable dominance. In one case U.S. firms have seized a commanding lead in just two years in the new laptop computer market and now account for more than 60 percent of U.S. sales last year, triple the figure for Japanese firms."

Does that mean U.S. firms now have a 60 percent share of the U.S. domestic market for laptop computers and Japanese firms have 20 percent? What share do we have of the Japanese market for laptop computers compared with Japanese firms in that market?

A.14. Data provided by a market research group for the U.S. computer industry show that since the United States entered the market for notebook computers in 1989, the U.S. share of the U.S. mar-

ket rose from 19 percent in 1989 to an estimated 64 percent in 1993. Over the same period the Japanese share of the U.S. market fell from 67 percent to 12 percent.

While we do not have data about the market for notebook computers in Japan alone, we were provided with information about the Pacific Basin countries as a group. Between 1989 (when U.S. manufacturers entered the market) and 1993, the U.S. market share increased from 1 percent to 23 percent; over the same period the Japanese share declined from 98 percent to 70 percent, as shown in the table below.

Notebook Computers: Percentage of Units Shipped by Manufacturer Location
(Percent)

	U.S. Market				Pacific Basin Market			
	U.S.	Japan	Europe	Other	U.S.	Japan	Europe	Other
1988	0	80	20	0	0	99	1	0
1989	19	67	14	0	1	98	1	0
1990	42	44	7	7	2	98	0	0
1991	62	24	4	10	14	83	*	3
1992	75	16	1	8	20	74	1	5
1993	64	12	*	24	23	70	*	7

*/ Less than 1/2 percent.

Source: InfoCorp, Computer Intelligence, 2880 Lakeside Drive, Suite 300, Santa Clara, CA 95054-2816.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM ALAN GREENSPAN

Q.1. You indicated in your testimony that the sharp increase in gold prices in recent months reflects heightened inflationary expectations. In the current environment, balancing out inflationary and deflationary forces that may be at work in the world economy, what gold price would satisfy you now that the market is not anticipating a loss in the dollar's purchasing power?

A.1. In my comments, I referred to a sharp increase in the price of gold, along with the behavior of a variety of other indicators, as signs of an apparent heightening of inflationary expectations. I did not have in mind any particular gold price level that would signal a market expectation of price stability.

Q.2. You indicated that recent policy directives have provided you with inter-meeting authority to tighten monetary policy. Yet, you also stated that the Fed's policy stance has not changed since last September, remaining generally accommodative. Are you concerned that this accommodative posture may now be contributing to inflationary expectations as reflected in the price of gold? If the present gold price is indicative of inflationary expectations, how much more must it rise before tightening becomes an appropriate policy response?

A.2. Our decision in May to create a directive for open market operations that was "asymmetric toward tightening" reflected two considerations: first, that the indications over the early months of 1993 regarding the rate of inflation and inflationary expectations were unfavorable, and second that short-term interest rates, adjusted for inflation, were unsustainably low and might have to be raised sooner rather than later if inflationary pressures did not subside. Our intention was to watch all of the incoming information for further confirmation of the risks, with the behavior of gold prices being one of many indicators that might shed light on the matter. We did not have in mind any trigger point for this, or any other particular variable, insofar as a possible reserve tightening action was concerned.

Q.3. You testified that due to the continued unreliability of money supply aggregates as a guidepost to monetary policy, the Fed would look to indicators such as real interest rates. You also stated that long-term rates are the most important for economic activity. How does the Fed Intend to measure a real interest rate for 30-year bonds given the difficulty of assessing inflationary expectations over such a lengthy period? Does the price of gold contain useful information with regard to inflation expectations for calculating the real rate on long-term bonds?

A.3. We would not perceive the price of gold as providing a direct indication of the inflation expectation that might be embodied in the 30-year Treasury bond yield. You are quite right that estimating the inflation premium in long-term rates is problematic. We do monitor a variety of surveys of inflation expectations; indeed, one is carried out under our sponsorship by the University of Michigan Survey Research Center in connection with its regular monthly consumer sentiment survey. We also think that something may be learned about changes in longer-rate inflation expectations by examining the behavior of the implicit forward short-term rates embedded in yield curve for long-term bonds; these are more likely to reflect such expectations than those relating to shorter-range cyclical developments, which should play a major role in, say two- or five-year Treasury notes.

Q.4. You have supported reduction, or even elimination, of the capital gains tax as a means to encourage risk-taking investment and thus spur economic growth. Would you expect a change in the capital gains taxation—for example, to index gains for inflation both prospectively and retroactively—to be welcomed in the market for long-term Treasury securities, or would such a step to encourage growth be considered inflationary and therefore lead to higher long-term interest rates, everything else being equal?

A.4. I would not think that reduction or elimination of capital gains taxes, in and of itself, would have a meaningful effect on inflation expectations.

Q.5. Would you expect a deficit reduction program of less than $500 billion to be regarded positively by the long-term bond market if it included provisions to reduce the taxation of capital gains?

A.5. My belief was that it likely would prove costly, in terms of near-term market reaction, if the Congress failed to pass a credible deficit-reduction package in the neighborhood of what had been long-discussed and generally anticipated. While it was my desire not to go beyond that and get into the debate regarding the specific revenue and spending components of such a package, I did restate my long held position that a reduction in capital gains taxes would be constructive for the economy.

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